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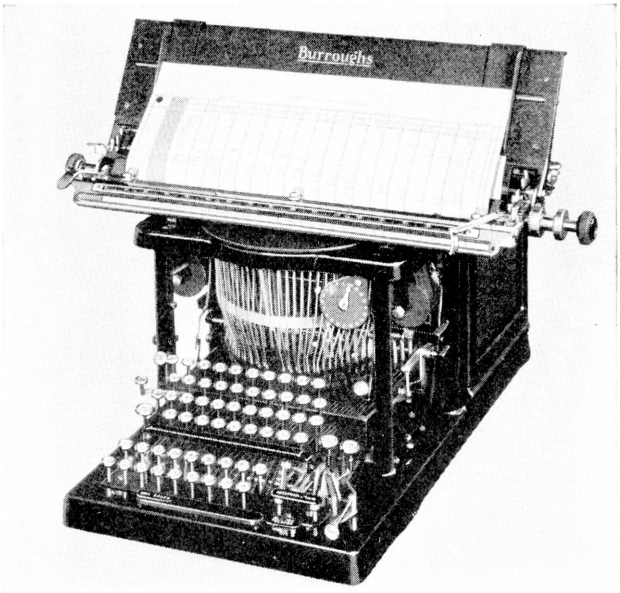

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The JOURNAL *of* ACCOUNTANCY

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A. P. RICHARDSON, *Editor*

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EDITORIAL

Quarterly Statements of Condition

Years ago financial writers adopted a plan of comparison of the earning statements of corporations, not only for fiscal years but for sections (chiefly quarters) of the years. It became a common practice to extract from the financial statements figures which would indicate the gross earnings from all sources, the operating earnings, the expenses and the net results for periods of three months, which were compared with similar figures for the corresponding three months of the preceding year. In time the public came to look for this sort of comparison and many an investor who had in mind the purchase or sale of securities was largely benefited by these comparative quarterly computations. There can be no doubt whatever that statements of this kind, when properly produced, offer an excellent means, but not necessarily the only means, of finding out the condition of a corporation. It is not always safe to assume that circumstances in corresponding periods are the same, and consequently a fluctuation in earnings may not be indicative of cause. For example, in one year there may be extraordinary occurrences which will lead to abnormal demand or to a total cessation of demand. To compare a normal year with the figures of such an abnormal period would be quite misleading. But on the other hand the comparative statement is, as a rule, a handy and rather good guide to financial standing. The New York stock exchange some time ago began to encourage the publication of quarterly statements of earnings, and a considerable number of the corporations whose securities are listed on the exchange responded readily. Most of the important and many of the smaller companies have made it a permanent part of their policy to issue quarterly statements, and their doing so has been an inestimable factor in maintaining confidence in the frankness of those corporations. It is possible, of course, to cover up many things under the cloak of publicity, but most of the statements which are issued are true, and consequently the public has been kept advised far more comprehensively than it was in the past of the changes and the general condition of the companies in whose securities there is public investment.

Stock Exchange Calls for Comparative Statements

Quite recently the president of the New York stock exchange addressed a letter to a number of corporations urging a general adoption of the practice of quarterly statements. In the course of that letter occurs a paragraph which raises a question that has been much discussed in the private deliberations of executive officers and directors. Mr. Whitney says:

"We find that the most usual objection to quarterly reports is based upon the seasonal nature of the business. While we believe that this can readily be overcome by the publication of comparative statements with previous years and such explanatory matter as may be necessary, nevertheless we are willing, where circumstances indicate the advisability, to substitute publication each quarter of the reports for the twelve months ending on the last day of the quarter. This seems to iron out all seasonal difficulties, and without a starting point for one particular quarter it is impossible to tell what the earnings for any given quarter may be. Such statements, however, when compared with the last quarterly statement of the same nature, do show the exact amount by which the most recent quarter is better or worse than the corresponding quarter of the preceding year."

The suggestion that statements be prepared for twelve months on the last day of each quarter certainly meets the criticism to which the paragraph quoted refers; but it does not seem probable to us that it will meet with cordial response from corporations, because it would involve more labor than the preparation of quarterly statements at the end of each quarter. Possibly this may have been in the mind of the president of the stock exchange and he may have put forward the scheme with the thought of meeting objections, not with any serious belief that many would adopt it. The great point to be observed is that the stock exchange is encouraging increasing candor on the part of its listed corporations. There must be a wide departure from past practice in order to meet the just demands of the investing public, and what the stock exchange is doing to help should bear substantial fruit. Accountants who advocate the publication of quarterly statements may perhaps be accused of self-interest, but surely no such accusation can be laid at the door of the New York stock exchange or any other organization of similar nature. The public now demands information, and everything which can bring about more comprehensive statements should receive hearty support. In considering the conditions recently revealed in England we have been moved to express a modicum of gratification because practice here is better handled than it is there, but that is not to say that we are perfect yet. American custom has a little reformation to undertake—and there is evidence that it will be undertaken.

The Flight to Stated Value

On December 15th newspapers contained a dispatch by the Associated Press from Wilmington, Delaware, to the effect that the stockholders of Warner Bros. Pictures, Inc., at their meeting on December 14th, approved the proposal of a five dollar stated value for the corporation's common stock. The dispatch adds, "Approval of this proposal gives the corporation a surplus of about sixty million dollars compared to the present earned surplus of $225,000. Officers of the company urged favorable action stating that the common stock had never had a stated value and that all cash ever received by the concern for its stock was considered solely as capital." It has long been the contention of many students of finance that the Delaware statutes permitting incorporation are far too elastic to be safe. It has been alleged and not contradicted that under the Delaware law it is permissible to regard practically the entire amount paid for stock as capital available for dividends. It is a little astonishing, therefore, to find that Warner Bros. Pictures, Inc., had been embarrassed by the lack of a stated value for its stock. It can not have been any legal obstacle which confronted the directors, but rather a question of sound business principles. Apparently the directors felt that in the absence of a stated value there was constant danger of diverting for dividend purposes what was not justly entitled to such treatment and could not be distributed without impairing the capital structure of the company. It appears that in the case of a well managed company the Delaware statutes may be innocuous. At any rate, it is interesting to find that a company of magnitude and importance feels the necessity for a stated value of its stock. The figures given in the press dispatch show a vast difference between the earned surplus and the fixed capital under the two different forms of capitalization. The first impression one would gain from consideration of the figures is that the stated value suggested by the directors and approved by the stockholders is far too low, if everything above that stated value is to be regarded as a source of dividends. Like all popular movements the trend toward stock without par value became almost an obsession with corporate directors and it naturally went to extremes. Now in the back-water of depression there is time to look about and see which way the current really runs most effectively; and it would not be astonishing to find that there would develop a reverse trend toward capital stock with a fixed par value. The truth of the matter is, of course, that there is merit in both forms of organization and each company should feel itself free to adopt the form most suited to the development of its activities and the effective handling of its finances. The action of Warner Bros. Pictures, Inc., is not the first of its kind but it is of great importance because of the size of the corporation and the widespread distribution of its stock.

Distribution of Practice

We have received a letter commenting upon an editorial note which appeared in The Journal of Accountancy for December, 1931, relative to the distribution of practice among accounting firms. Our correspondent says:

"It seems to me that this title is too comprehensive. What the editorial deals with is the distribution of practice only in so far as it relates to corporations whose securities are listed on the New York stock exchange. This, it seems to me, is a thing quite different from the distribution of accountancy practice in general. There is, I think, cause for gratification among accountants everywhere that so large a percentage of the listed companies are now audited. A few years ago the situation was far otherwise. It may be, as you suggest, that the concentration of these particular audits in the hands of a relatively small number of firms is unhealthy. I would certainly agree with you if, say, all of this work were concentrated in the hands of one firm. Whether 102 firms is too small a number is, I believe, open to debate. Any way, isn't it one of those matters in which the public has a deciding voice? For illustration, there are many fire-insurance companies throughout the country, but the bulk of the business is done by a comparatively small group. Then again, there are some thousands of lawyers in New York, and yet the legal work in connection with the issuance of corporate securities is confined almost entirely to about half a dozen firms. I have no idea how many corporations throughout the country have their accounts audited, but the number must run into large figures. If a distribution of this total could be computed, the results would be much more significant and would certainly show that the larger firms do not have such an undue proportion of the business as might be inferred from the stock-exchange total."

The criticism contained in this letter is justified. The editorial note did fall short in that it failed to point out the narrow application of the comparative figures. There was no intention to infer that the conditions revealed in the list of securities listed on the stock exchange should be regarded as an index to the entire practice of the country. As a matter of fact, there is a great deal more practice numerically among unlisted companies, firms and personal enterprises than there is in the corporations whose securities are on the list of the New York stock exchange or of all stock exchanges. The question of the relative value to the practitioner of the listed corporation audits and those of concerns which are unlisted can not be answered with anything approaching assurance. No one can possibly tell with even a fair degree of accuracy. There is, however, no doubt at all that accountants have more clients who are not directly interested in stock-exchange listings than they have among the listed companies. Probably it is true, as our correspondent points out, that the public is the deciding factor. What we were attempting to argue was that it would be healthier if there could be a wider distribution of accounting for the listed companies and also throughout the country. The notion may be idealistic, but there will always be many accountants who will feel that there should be an absolutely equitable distribution—and it should be added, of course, that there are lawyers, doctors, architects and a host of others who cherish the same Utopian dream.

Other Times, Other Customs

The conditions existing in the business world today constitute an attack on the citadel of custom, and we are witnessing reversal of sentiment and changes of policy which would have been regarded as very remotely possible only a few years ago. During the first year of the descent men clung to the old traditions and displayed a pride in slogans like, "Business as Usual," "Wages Maintained," "Production Continued" and a dozen others. No one could foresee the protracted nature of the depression and there seemed to be no justification for a departure from established precedent. Then came the second year and there was a willingness to admit hard times, but still tradition prevailed and we heard a great deal about the virtues of high wages and keeping the machinery running, although much of this expressed sentiment was merely whistling past the graveyard. Employers of labor were compelled to cut the rates of pay even while they were ostensibly glorifying the old wage scales. Then we came into the third and, let us all hope, the last stage of the transition from boom to normal conditions, and it is in this last stage through which the world is now passing that the attack upon the strongholds of policy has become effective. The capitulation is taking place. We are hearing less about a return to the so-called good times of '28 and '29 and more about the true level of business in times of steady, moderately profitable and growing activity. We are not far above the plane of the years immediately preceding the war. Prices of commodities are lower than they ever have been in the memory of any living man. Transportation and other factors in distribution have slipped back into a state only slightly better than that which existed in 1913. Some of the elements in the cost of living are not yet adjusted as they must be. The great exception, of course, is in the rents for dwellings, particularly in and about the great cities. Fuel, too, is far above the cost in the ante-bellum days; but food, clothing and many of the incidentals are back where they were.

The Question of Values

Now one of the extraordinary features of the present condition is that while prices are approximately normal, the market values of securities are nearing the neighborhood of their position before the war and the actual volume of business transacted is really fairly satisfactory, the convulsion which is taking place, in men's minds chiefly and to some extent, of course, in their manners, is creating an apparent necessity to depart from the customs of a generation. As an illustration of this extraordinary phenomenon let us consider two or three recent evidences of a willingness to adopt new methods to meet new problems. Probably the greatest factor in the financial distress is the falling value of gilt-edged securities. Bonds which are as good as anything can be in this world are being sold, because of the need to realize, at prices which are out of all proportion to their intrinsic values; and like a great snow-ball this tendency grows as it travels. Consequently the asset values held by banks, insurance companies, fiduciaries and other great investors have so declined that there is an appearance of something like insolvency when as a matter of fact there actually is financial health. As a result we find the clearing house, the banking departments, the insurance commissions and similar authority openly advocating a method of valuation which would have been considered radical and even dangerous a year ago. The old principle that assets should be valued at cost or at current market prices, whichever were lower, if followed today would indicate in many cases an excess of liabilities over assets. In other words, if the securities now held had to be sold at current market quotations the loss would be disastrous. In all normal times the doctrine of cost-or-market, as it is called, seems to be sound, even if it be not absolutely logical. But when a market ceases to exist it is rather difficult to compute the difference between cost and market value.

An Arbitrary Plan Seems Necessary

It has always been the steadfast belief of the accounting profession, with a few exceptions, that the adoption of the principle of cost-or-market was desirable and that it certainly tended toward conservative estimates of condition. Today, however, there seems to be no bottom to the market and securities of the highest class are changing hands at prices which would be ridiculous if they were not so tragic. In the circumstances, therefore, there seems to be every reason to approve the action of various authoritative commissions and organizations in sanctioning a scheme of valuation based upon neither cost nor market but rather upon an arbitrarily fixed deduction from cost. For example, if a long term, first-mortgage bond supported by property of undoubted worth, and yielding, let us say, five per cent.

at par, is now selling at fifty there can be no common sense in insisting that where no liquidation is necessary the asset value should be reduced to fifty. As a matter of fact, in such a case as that which we are considering the bond will be held in all probability until maturity and will be paid in full. There might be some justification for carrying such a bond in the balance-sheet at par on the theory that in the long run the par value will be received, but it is always well to take into account the possibility of liquidation. Consequently there should be a reduction in the estimate of actual value which would reflect to some extent the existing conditions. At what point valuation should be fixed is, of course, purely a matter of opinion, but it is clearly out of the question to allow each holder of securities to adopt its own theory of valuation—we are speaking now of supervised institutions—and accordingly there must be an arbitrary percentage of cost or par to be deducted in the published statement of assets. The figure which has been mentioned more than any other is twenty-five per cent. If that is to be the prevailing basis, the bond which we have been discussing would be shown on the balance-sheet of the holder at seventy-five. In other words, a mean between market and cost is chosen. As a matter of fact, the present market prices of a group of bonds representing all reasonably good securities would probably produce about fifty per cent. of the par value, and if the twenty-five per cent. reduction is followed the result will be a fair compromise between a terrified market and a sane value.

A Temporary Expedient Merely

If this policy is carried out, as it probably will be, we shall doubtless hear a great deal about the total fallacy of the cost-or-market theory. Those who do not believe in that theory will be inclined to regard the action taken as a demonstration of the correctness of their opinion and, of course, they will be justified in such a contention, at least on the surface; but the great point to be remembered is this, that in times of crisis many things may be done, and wisely done, which in other times would be extremely unwise. The history of business and finance has shown that over a period of years, taking into consideration all common factors, the safest and best method of valuing assets is under this same theory of "cost or market whichever is lower." When the present crisis shall have passed we shall revert to our ordinary manner of life, and then, when we want to know what we have and what it is worth, we shall go back to the old and generally accepted theory. When the troops go out to war they leave behind them the common vocations of life, but when the war is over they lay down uniform and arms and, we trust, hate, and they take up the march of calm steady progress. What was done in war is not required in peace. So in this warfare between sense and fear, in which fear is the arch enemy, we are obliged to do some things not in harmony with what we believe to be sane procedure. The measures for avoidance of disaster will not be required when disaster ceases to threaten. Today it is well, no doubt, to adopt the plan which will meet the emergency, but that should not be regarded as any reason or justification for extraordinary measures after the danger is past. There will be a great deal of discussion among accountants, economists, engineers and business men generally about this new policy of an arbitrary valuation of assets. No one will care to be recorded as an advocate of any particular percentage in reduction of values. If twenty-five per cent. is to be accepted there will be plenty of argument to prove that twenty or thirty or some other percentage would have been infinitely better. Those who will argue will, no doubt, derive a great deal of comfort from the exercise, but the fact remains that where such an extraordinary policy is to be adopted there must be an arbitrary decision and if it be not the best it will be at least effective. And if it will prevent an appearance of bankruptcy where none exists, it is to be welcomed, whether it be in accordance with the tenets of the financial creed or not.

Secret Reserves Always Deceptive

Without intention to reopen discussion upon the Royal Mail case, which led to the conviction of Lord Kylsant, it seems desirable to return to the subject for a moment to point out a most excellent summary of the conditions which brought about the conviction and a condemnation of the procedure which made such conditions possible. Judges, counsel and a host of writers and speakers have been explaining exactly what each one felt to be the nature of the deception in the prospectus of the Royal Mail Company, which was the basis of the action in which the crown won against the shipowner. It remains for an accountant to express the matter in a most terse and incisive way. At a meeting in the guild hall at Hull, England, Henry Morgan, president of the Society of Incorporated Accountants and Auditors, referred to the Royal Mail case at some length. In the course of his remarks he used the following expression, which seems to us to sum up the whole matter:

> "It should be borne in mind that a secret reserve can arise only through an understatement of profit, and in no other way, and it can not be denied that balance-sheets or profit-and-loss accounts which are affected by secret reserves are untrue to the extent of such reserves."

Columns of newspaper space and hours of oratory could not be more definite nor more accurate. *The Economist,* of London, commenting upon Mr. Morgan's statement says,

> "The question of disclosure is so fundamental for investors that Mr. Morgan's forthright contribution must be regarded as a public service, calculated to stimulate active discussion of a matter which can not be left in its present unsatisfactory state."

The Economist is a weekly paper which has never been accused of radicalism. When so influential an organ cries out for reform the prospects brighten.

"Thousands in Commissions"

A recent circular letter emanating from a firm of brokers in New York contains the following statement:

> "We are happy to state that we have been able to pay many thousands of dollars in commissions to accountants who have referred issues to us and we hope this may be the means of establishing a profitable business relationship with you."

This statement is distressing in many ways. In the first place it is evidence of a lack of understanding of the professional integrity of accountancy. It shows that the firm from which the letter comes does not know that no reputable accountant can or would accept a commission of that sort. In the second place the statement, if true, reveals a depravity which we had not suspected. Everyone knows that there are in every profession a few men who are lost to a sense of decency and to whom the appeal of the dollar is irresistible, but we stand aghast to learn that many thousands of dollars in commissions have been paid to accountants. The allegation conveys the impression that these dollars have been widely distributed, but, of course, it might be true that the many thousands had been paid to merely two culprits. In the third place if this letter should fall into the hands of the clients of accountants and if it should be believed by the recipients, what a blow would be struck to the standing of the profession. Let us imagine, if we can, a client who learns that his accountant or his lawyer or any other professional advisor is accepting commissions for diverting business of any kind to persons who would pay commissions. There is no reason in the world why a firm of brokers or any one else, if it be compatible with the code of ethics, should not employ solicitors to go out and find business and bring it in, provided the solicitor is that and nothing more; but when a professional man is engaged to render a professional service and takes advantage of that relationship to throw business to another employer—for that is what the payer of commissions becomes—it is difficult to find words to describe such a person. It might be interesting to ask the authors of letters of this kind—and there are many of them—to specify. In other words they should give us the names if we are to believe that accountants are accepting thousands of dollars or even a few cents in commissions. General condemnation of a profession such as is conveyed in the paragraph we have quoted is grossly unjust and contemptible.

Another Panacea

A correspondent who, like most other people, has been confused and distressed by the political gymnastics of congressmen of both parties, writes to suggest a way out of all our difficulties. He says that it would be a good plan to allow congress five days a week to speak for the record and one day a week to take action. All the remarks of the five days might be made for the benefit of the constituencies and the action of the one day be taken for the benefit of the country. The five days should be public days and the one day secret. Carrying this suggestion a little further it might be possible to accomplish something really helpful. For instance, if the subject of international debt settlement were brought up on the floor of the house or the senate every orator and politician might find an opportunity to wave the flag, damn all mankind beyond the borders of America and insist vehemently that the uttermost farthing of principal and the last sou of interest be paid at once. This would have a wonderful effect upon the constituencies and the people who sent these men to congress would be convinced that they had done a good job, that they had selected men who would not be led astray by the insidious blandishments of foreign emissaries. Every one would be happy and even the two or three men who might have courage enough to speak their minds on the public days would not be greatly despised, because their efforts would be futile. Then on the sixth day there should be a secret session and a secret ballot. Suppose that some one should suggest the wiping out of all international indebtedness except the private loans, and a bill should be introduced authorizing such cancellation. Most of the men in congress have had enough experience to know something of business. Their public utterances should not be regarded as truly representative of their mentality or knowledge. It might seem to these men that the cause of business, commerce and prosperity would be best served by making the most of necessity and frankly forgiving the debts. Nearly every one knows that many of these debts can never be collected—then why not make a virtue of the inevitable? Now on the sixth day if such a problem were presented and some scheme of absolute secrecy could be devised so that each congressman or senator could drop a ballot without any possibility of identification, it might be conducive to honesty; and perhaps these men thinking of the country, rather than of the folk back home, would vote as they in their own hearts believed they should vote. In such circumstances it might be found that many a bill which today has no hope whatever would pass by substantial majority and that many a bad bill which is required by the pusillanimity of political ambition would fail to pass. There is a great deal to be said for such a proposal as this. It is not quite fair to members of congress and senators to have their official utterances regarded as the expression of their real thought. There are many other questions besides those of a fiscal character which would be enormously assisted toward solution if there could be anonymous voting. It has even been suggested that some of the most commonly discussed matters of legislative enactment would never have reached the statute books if it had not been for the gallery.

Effect of Foreign Exchange Fluctuations on Profits

By John F. Sells

International trade is the result of the desire on the part of those engaged therein to realize profits either directly from the trade itself or indirectly from its effect on prices and profits in their domestic trade. The activities of the exporter are based upon his desire to increase the volume of his business by taking advantage of trading opportunities in foreign markets and to increase his profits as a result. On the other hand, the importer desires to buy merchandise in foreign countries at advantageous prices so that he may sell in his own country at a profit. From their knowledge of commodity prices and markets, persons engaged in business may be competent to judge the trading possibilities in foreign countries so long as the relative exchange values of the currencies involved in which prices are stated remain constant. However, when the relative exchange values of the currencies fluctuate, the amounts to be paid for merchandise or to be realized on its sales are no longer certain but depend to a considerable degree upon the value of the foreign currency as indicated by the current exchange rates, so that fluctuations in exchange rates introduce an element of uncertainty and speculation into the results of international commercial transactions.

In the following discussion the term "American" is used to mean of or belonging to the United States.

Whenever business transactions involve more than one currency they are affected by changes in the relative exchange value of the currencies involved, as indicated by the quoted exchange rates. The trading profit or loss from the transaction itself may be directly increased or decreased as a result of changes in exchange rates, or there may be a gain or loss resulting from the actual conversion of the proceeds from one currency to another, known generally as a foreign-exchange gain or loss. The variations in exchange rates affect trading profits or losses only when there is a change in the relative exchange value of the currencies involved in a business transaction. If a business transaction involves two currencies both of which fluctuate in value relative to gold but maintain the same relation one to the other, there can be no gain nor loss due to exchange fluctuations on the transaction.

As an illustration let it be assumed that a company, operating in the Argentine, sells part of its product in Great Britain. If the Argentine paper peso is quoted at 40 cents U. S. and the pound sterling at $4.80, the sale for £1 of an article costing 10 pesos would realize a profit of 2.00 pesos to the Argentine company. American currency is used in this illustration because at the present time it is equivalent with gold. The same profit would be realized in pesos if the value of the Argentine paper peso were worth 36 cents U. S. and the £ sterling $4.32, a drop of 10% in the value of each currency. If, however, the value of the Argentine paper peso remains unchanged while that of the £ sterling drops to $4.32, the trading profit to the Argentine company will be only .80 pesos. This difference in profit may be defined as a decrease in the trading profit due to the decline in the exchange value of the £ sterling. If the Argentine company were a wholly owned subsidiary of an American corporation, the trading profit would in the first case be 80 cents U. S., but after the decline of 10% in the £ sterling and Argentine peso the trading profit on the transaction would be only 72 cents U. S. It is therefore apparent that variations in value of foreign currencies are of considerable interest to American companies doing business in foreign countries.

Referring again to the foregoing illustration it should be noted that if the proceeds of the transaction were not converted until some time after the completion of the transaction, and in the meantime there had been any change in the relative value of the Argentine and British currencies, there would be an exchange gain or loss representing the difference between the amount which would have originally been obtainable in Argentine currency and the amount actually remitted. It should be noted that in the illustration used if the transaction were completed before the 10% decline in the value of both the £ sterling and Argentine peso but the proceeds were retained in the Argentine until the value of the Argentine peso had fallen to 36 cents U. S., the profit to the American company would be 72 cents U. S. The difference of 8 cents would represent the exchange gain or loss resulting from the delayed conversion of the foreign proceeds. The term "foreign exchange gain or loss" generally refers to gains or losses which are attributable to the retention of current assets in foreign countries.

When goods are purchased in a foreign country and payment for them is to be made in the currency of the country in which the purchases are effected, the purchaser must meet his obligation in that currency. If the relative value of the foreign currency decreases, the purchaser can acquire the required amount of the foreign currency for a less amount of his domestic currency, and his merchandise purchases therefore cost him less in his own currency. As a concrete example take the case of an American company purchasing raw materials in Canada. Under normal conditions the difference in the exchange value of American and Canadian dollars is negligible and, except for transactions of considerable magnitude, the effect of such variation may be disregarded. When the value of the Canadian dollar drops to 80 cents U. S., however, a purchase involving $1,000 in Canada may be settled by remitting $800 U. S. The effect of changes in the relative value of the two currencies is, therefore, to decrease the cost of the commodity to the purchaser when the relative value of the foreign currency falls and, conversely, to increase the cost when the foreign currency rises. If the particular foreign country is either the only source of supply for the material or the dominant factor in the market, any rise or fall in the relative value of its currency immediately affects the profit or loss of the purchaser by its effect on the cost of the material used and on the market value of the material on hand or in transit. It may be noted that if the foreign market price converted to the domestic currency of the purchaser at the current rate of exchange at the inventory date results in a price less than the actual cost in domestic currency, the inventory prices should be reduced to the converted foreign market price, but, if the actual cost in domestic currency is the lower, no adjustment should be made, thus complying with the rule governing inventory valuations, viz.: "cost or market, whichever is lower."

This rule also applies to purchases made by a foreign subsidiary for the parent company so that inventory on hand in the foreign country awaiting shipment need not be adjusted to give effect to lower foreign market prices unless the foreign market prices converted into the parent company's domestic currency give a value less than the actual cost in that currency. If the relative values of the currencies involved become stabilized on a new basis the domestic market price of the commodity will be affected eventually although the foreign country may not be a dominant factor in the market, since (ignoring the effect of tariffs) if the relative value of its currency rises, the cost in the domestic currency of the material purchased abroad is increased so that the domestic goods are cheaper. This will lead to an increased domestic demand, which will tend to increase domestic prices until a state of equilibrium shall have been reached. Conversely a decline in the value of the foreign currency reduces the cost of the foreign goods in domestic currency thus tending to increase the demand for the foreign goods, which will result in raising the foreign market price until a state of equilibrium shall have been reached with the domestic market. In order to protect himself against a rise in the exchange value of the foreign currency the importer should purchase an amount of foreign currency equivalent to his material purchases as soon as he has contracted for the merchandise; otherwise a rise in the relative value of the foreign currency will increase the cost of the merchandise expressed in his domestic currency.

The shipment of goods to a foreign country for sale at prices fixed in the shipper's domestic currency does not result necessarily in gains or losses when the foreign currency rises or falls in relation to the other currency. A decline, however, in the relative exchange value of the foreign currency would compel the foreign customer to pay more in his own currency for the goods and thus increase the "sales resistance" and tend to decrease the volume of shipper's sales in the foreign country. The increase in sales price expressed in the foreign currency would be accompanied by lower distribution costs to the shipper stated in his currency, since the foreign expenses payable in that currency would not be adjusted immediately to the fall in value of the foreign currency, unless they were computed on the basis of the sales prices. Therefore, if the sales price and volume can be maintained the foreign business will yield greater profits when the value of the foreign currency declines. In the same manner a rise in the relative value of the foreign currency would result in reduced selling prices expressed in the foreign currency, reduced "sales resistance," an increase in volume and increased distribution expenses expressed in the domestic currency of the shipper. The following statement shows the effect of the decline in the value of the £ sterling upon the accounts of an American shipper whose products are sold in England at prices fixed in American currency:

	£1 = $4.80	£1 = $3.84
Net sales	$4,800	$4,800
Cost of sales	4,000	4,000
Gross profit	$ 800	$ 800
Selling expenses, etc., payable in foreign currency—£100	480	384
Net profit	$ 320	$ 416

In the illustration it should be noted that although the net sales in United States dollars is the same in both cases, the amounts paid by the British customers would be £1,000–0–0 in the first case and £1,250–0–0 in the second. If at the time of sale the American shipper accepts £ sterling from his customers at the ruling rate of exchange in payment of his dollar invoices and does not immediately convert the receipts into American currency he would suffer an exchange loss if the value of the £ sterling declined. For example, if the goods were sold for £1,000 when the £ sterling was worth $4.80, but the proceeds were deposited in a sterling account until after the value of the £ sterling had dropped to $3.84, the American shipper would be able to get only $3,840 for the £1,000 and would suffer an exchange loss of $960 due to his delay in conversion of the £ sterling into dollars. On the other hand, if the value of the £ sterling had increased to $4.85 the £1,000 would buy $4,850 and there would be an exchange gain of $50. It is therefore apparent that leaving the proceeds of business transactions in foreign currencies results in profits or losses which are speculative in nature.

When goods are shipped to a foreign country for sale at prices fixed in the foreign currency any change in the relative values of the two currencies involved directly affects the profits of the shipper, since the sales prices expressed in the domestic currency vary directly with the relative value of the currencies involved while the cost to the shipper is not affected. This is illustrated by the following statement showing the effect of values of the £ sterling of $4.80 and $3.84 on the profits realized by an American concern on sales made in sterling:

	£1 = $4.80		£1 = $3.84	
	£	$	£	$
Net sales	1,000–0–0	4,800	1,000–0–0	3,840
Cost of sales		4,000		4,000

	£1=$4.80		£1=$3.84	
	£	$	£	$
Gross profit or *loss*		800		*160*
Selling expenses, etc.	100–0–0	480	100–0–0	384
Net profit or *loss*		320		*544*

If there are other sources of supply which are not affected by the fluctuation in the relative value of the currencies in question, an increase in the relative value of the foreign currency would result in a competitive advantage to the shipper, since he could reduce the foreign currency price and still maintain the same margin of profit in his domestic currency. Assuming an increase in the value of the £ sterling from $4.40 to $4.84 the following statement shows the adjustment which may be made in the sterling selling price by an American shipper and still realize the same profit:

	£1=$4.40		£1=$4.84	
	£	$	£	$
Net sales	1,000–0–0	4,400	918–3–7	4,444
Cost of sales		3,600		3,600
Gross profit		800		844
Selling expenses payable in £ sterling.	100–0–0	440	100–0–0	484
Net profit		360		360

It should be borne in mind that (if the foreign sales expenses do not vary directly with sales prices) an increase in the exchange value of the foreign currency results in increased costs of distribution to the shipper and, vice versa, a decline results in decreased distribution expenses; but these adjustments do not offset the effect of variations in exchange rates on the trading profit, as the amount of expenses involved generally must be much less than the sales. If the relative value of the two currencies becomes stabilized on a new basis, the selling prices in the foreign currency will tend to adjust themselves to the new relative values, unless other sources of supply which are not affected by the fluctuations in the currencies involved, control the situation. It will be seen, therefore, that when sales are made in a foreign currency the trading profits or losses expressed in the shipper's domestic currency are directly affected by exchange fluctuations. In addition, if the shipper allows the proceeds to remain in the foreign currency he will suffer an exchange loss if the foreign currency goes down and will realize an exchange gain if it goes up, and by delaying the conversion into his domestic currency he speculates on the future exchange rates. If the shipper wishes to eliminate speculation from his foreign business he should—

1. Create a foreign currency debt equal to the cost of the goods shipped abroad by either selling an equivalent amount in the foreign currency and realizing domestic currency therefor or borrowing an equivalent amount in the foreign currency and transferring the proceeds into his domestic currency.
2. Transfer the net proceeds of all sales into his domestic currency, as they are received.

By following this procedure the speculative risk involved in the foreign business would be restricted to the unrealized profit on goods shipped for sale in the foreign country and unsold. If the goods are sold the full amount of the sale should be covered by the sale of foreign currency when the sale is made, so as to protect the realization in the shipper's domestic currency.

The effect of fluctuations in the exchange value of foreign currencies upon commercial transactions has been discussed and it has been shown that trading profits are affected by exchange fluctuations and that when the proceeds of sales are retained in a foreign currency any fluctuations in the relative values result in exchange gains or losses to the shipper. When business in a foreign country is conducted by a foreign subsidiary, not only are the trading profits of the parent company affected by changes in the relative values of the currencies involved, but the company is also subject to exchange gains and losses, since the value of the net assets of the subsidiary in the currency of the parent company varies directly with the relative value of the foreign currency. The rule for obtaining the sound value of the net assets of a subsidiary operating in a foreign country is that (a) all capital assets should be carried at the cost to the parent company in its currency, i. e., they should be converted to the currency of the parent company at the rates prevailing when the assets were acquired, and (b) all other assets and liabilities should be converted at the current rate of the date of valuation. It may be noted that for convenience the property accounts should be carried in both currencies and that depreciation should also be computed in both currencies.

So far as the parent company is concerned the profit or loss on the operations of its foreign subsidiary, after allowing for dividends received, is measured by the change during the period in the value of its foreign net assets expressed in the parent company's currency. If the exchange value of the foreign currency expressed in the domestic currency of the parent company remains constant throughout the period, the subsidiary's profit or loss in the parent company's domestic currency will be equivalent to the profit or loss realized on the subsidiary's regular trading operations converted at the prevailing rate of exchange. The amount of the foreign subsidiary's operating profit or loss expressed in the parent company's currency is obtained by converting the results, before deducting depreciation as shown by the subsidiary's books, into the parent company's currency at the average rate of exchange for the period. The provision for depreciation should be computed in both currencies by applying the rates used to the property values expressed in the two currencies. The following tabulation indicates the procedure in the case of a British subsidiary of an American corporation, assuming the average exchange value of the £ sterling during the period to be $4.25 and the average cost of the properties to be at the rate of £1 = $4.80:

	£	Rate of conversion	$
Net profit before depreciation	10,000–0–0	4.25	42,500
Deduct depreciation	1,000–0–0	4.80	4,800
Net profit	9,000–0–0		37,700

If, however, the value of the foreign subsidiary's currency expressed in the parent company's currency has fluctuated during the period, there will be an additional gain or loss to the parent company resulting from the conversion of the net current assets at the current rate of exchange at the end of the period. The following statement illustrates the method of determining the gain or loss to the parent company resulting from the fluctuation of exchange rates:

Net worth of subsidiary at beginning of period expressed in the parent company's domestic currency determined as above.....

Add profits or *deduct* losses on operations of subsidiary converted into the parent company's domestic currency at the average rates prevailing during the period..............................

Deduct:
Dividends paid, converted into the parent company's domestic currency at the current rates as of the date of payment.....

Total net worth of subsidiary at end of period, expressed in domestic currency of parent company before adjustment with respect to exchange...

The net worth of the subsidiary in the parent company's currency at the end of the period should then be obtained by conversion of its balance-sheet, as indicated above, and the difference between the amount so obtained and the net worth shown by the tabulation represents the exchange gain or loss. It may be stated that the exchange gain or loss is due to the following factors:

a. The change in the relative value of the currencies.
b. The change in the amount of the net current assets carried in the foreign currency during the period.

Obviously it is impossible for a commercial concern to exercise any control of foreign exchange rates which indicate the relative values of various currencies, but it is possible to minimize their effect by maintaining at a minimum the net current assets carried in the foreign currencies. The following statements show the computation of the value of the net assets in American currency of a wholly owned English subsidiary, assuming various amounts of net current assets and the exchange loss resulting from the decline in the value of £1 sterling from $4.80 to $3.84 during the period:

	Assuming that the net current assets					
	(a) Increased during the period		(b) Decreased during the period		(c) Remained the same throughout the period	
	£	$	£	$	£	$
Net worth at beginning of period..........	1,000–0–0	4,800	1,000–0–0	4,800	1,000–0–0	4,800
Add—profits for the period............	500–0–0	2,160	500–0–0	2,160	500–0–0	2,160
Deduct—dividends paid	*250–0–0*	*1,080*	*750–0–0*	*3,240*	*500–0–0*	*2,160*
Net worth at end of period before exchange adjustment..	1,250–0–0	5,880	750–0–0	3,720	1,000–0–0	4,800

	Assuming that the net current assets					
	(a)		(b)		(c)	
	Increased during the period		Decreased during the period		Remained the same throughout the period	
	£	$	£	$	£	$
Balance-sheet at end of period						
Fixed assets.......	250–0–0	1,200	250–0–0	1,200	250–0–0	1,200
Net current assets..	1,000–0–0	3,840	500–0–0	1,920	750–0–0	2,880
Net worth at end of period...........	1,250–0–0	5,040	750–0–0	3,120	1,000–0–0	4,080
Exchange loss........		$840		$600		$720

In this statement the profits for the period and dividends paid have been converted to dollars at the average of the exchange rates at the beginning and end of the period, on the assumption that:

(a) The profits were earned throughout the period in proportion to the elasped time.
(b) The dividends were remitted in proportion to the profits earned.
(c) The rate of decline in the exchange value of the £ sterling was consistent throughout the period.

The following analysis of the exchange losses may be of interest:

	(a)	(b)	(c)
Loss due to reduction in dollar value of sterling net current assets at end of period..........................	$720	$480	$720
Difference between dollar value of £250 at beginning of period and its dollar equivalent remitted as dividends.		120	
Difference between dollar equivalent of the undistributed earnings (£250) and its dollar equivalent at the end of the period..................................	120		
Totals......................................	$840	$600	$720

In all cases there is a foreign exchange loss resulting from the decline in dollar value of the sterling net current assets on hand at the end of the period. In (a) there is an additional exchange loss due to the increase in the sterling net current assets during the period. In (b) there is an additional exchange loss, representing the difference between the dollar value at the beginning of the period of the £250, remitted as dividends in excess of the current earnings, and the dollars remitted. In (b) the aggregate exchange loss is less than in (c), due to the remitting of £250 during the period at a rate above the closing rate. And it should be noted that in order to obtain this result it is not necessary that the remittance to the parent company be in payment of a dividend. Suppose that the £250 remitted were charged to the current account of the parent company, it would appear as an asset on the subsidiary's balance-sheet and on conversion would be valued at the closing rate $3.84, or $960, and since the dollar equivalent of the remittance was $1,080 there would be an exchange loss of $120. The parent company would show on its books a liability of £250 equivalent to $1,080, being the dollar equivalent remitted, but at the closing date it would revalue the liability at the closing rate to $960, thus making an exchange gain of $120, exactly offsetting the exchange loss obtained by the conversion of the item in the foreign subsidiary's balance-sheet. It may be noted that before the conversion of the foreign subsidiary's balance-sheet all intercompany accounts must be reconciled and brought into agreement with the balances on the parent company's books or with those carried by other subsidiaries, using the current rates of exchange for the conversion of balances carried in foreign currencies. It should also be noted that the net exchange gain or loss on intercompany accounts is nil, since a gain to one company is offset by a loss to the other. It may be observed that when a company owns several subsidiaries operating in various countries, each of them having business transactions with the others, it is impossible to state definitely the ultimate exchange results by companies, since the offsetting results on the books of all companies should be taken into consideration. In this case the only result capable of accurate determination is the exchange gain or loss to the entire group of companies.

From the foregoing discussion it would appear that so long as a company carries current assets in foreign currencies it will be subject to foreign-exchange gains and losses with the fluctuations of exchange rates and that the amount of these gains and losses depends upon the amount of the current assets maintained in foreign countries. It follows, therefore, that the speculative risk due to fluctuations in exchange rates may be reduced by decreasing the amount of foreign current assets. This may be accomplished in two ways: the foreign subsidiary (with the support of the parent company) may borrow locally in foreign currency to approximately the amount of its net current assets or may sell foreign currency up to the same amount. In both cases the amount realized should be immediately converted into the currency of the parent company and remitted to it.

There remains the case of a company with a wholly owned foreign subsidiary which sells part of its product in a third country. An American company with a wholly owned subsidiary operating in the Argentine which sells part of its product in Great Britain in pounds sterling is chosen for the purpose of illustration. Assuming that the Argentine company obtains all its raw materials in its own country, it may be stated that the cost of its product will not be affected by the frequent variations in the value of the Argentine currency. Also the changes in the value of Argentine currency as reflected by the exchange rates will not affect the trading profits in pesos on business transacted in the Argentine, although the profits stated in dollars will be affected by any change in the relative value of dollar and peso. The results of the business transacted with Great Britain will be affected, however, by the daily changes in the relative values of the £ sterling and the peso as reflected by the quoted exchange rates, since a decline in the relative value of the £ sterling will reduce the amount of sales stated in pesos and, vice versa, an increase in its relative value will increase the sales stated in pesos, with in each case corresponding changes in the foreign expenses as stated in pesos. Not only will the value of sales and foreign expenses be affected by the changes in the relative value of the currencies, but the value of all current assets of the Argentine company in Great Britain and any inventories either in transit from or in the Argentine for sale in Great Britain will also be affected. The inventories in Great Britain and goods in transit to Great Britain, including those awaiting shipment in the Argentine, will be sold in pounds sterling, and their value is not affected by changes in the value of the peso, so these assets should be carried for accounting purposes in both currencies on the Argentine books as well as all other current assets in Great Britain, and the peso equivalent of the £ sterling balances should be adjusted at each closing date by conversion of the £ sterling balances to pesos at the current rate. The original £ sterling value of the inventories would be obtained by converting the peso cost at the current rate at the date of valuation, unless the value so obtained is more than the market. In that case the market value in £ sterling should be taken. In order to state correctly the inventories, whether in Great Britain, in transit from the Argentine or in the Argentine awaiting shipment at any closing date their market value in £ sterling should be obtained, and, if that value converted to pesos at the current rate be less than the cost in pesos, an adjustment should be made on the Argentine books to reduce the valuation to the converted British market price. Since the Argentine company is owned in America the ultimate recipient of its profits is the parent company in America and the amount is finally measured in dollars. Consequently, in order to eliminate so far as possible the speculative element in the foreign results the companies should—

1. Maintain the current assets in the Argentine at a minimum.
2. Maintain the current assets carried in £ sterling at a minimum.
3. Remit all profits realized in the Argentine to the American Company as and when earned.
4. Remit the proceeds of sales made in Great Britain when received in pesos to the Argentine Company up to the cost of the goods sold and the balance in dollars, representing the profit realized, to the American Company.

This would necessitate borrowing in the Argentine in pesos and in Great Britain in £ sterling.

It is sometimes argued that, if a company makes investments in foreign countries which it intends to maintain substantially unchanged in the foreign currencies, it is not necessary to revalue the net current assets in the foreign currency at the current rate of exchange in order to determine the profit or loss on the business, although the greater part of the parent company's investment in the foreign subsidiaries may be represented by foreign current assets. In accordance with this theory the profits or losses of the foreign subsidiary would be remitted to the parent company and would be converted at the current rates of exchange in order to determine the profit realized by the subsidiary. The investment account on the parent company's books would remain unchanged so long as the withdrawals in foreign currency made by the parent company were equivalent to the profits earned by the foreign subsidiary. This procedure would permit the parent company to take up on its books the trading profit of the foreign subsidiary and would be substantially correct, providing the net current assets of the foreign subsidiaries were kept as nearly as possible to zero or if the exchange value of the foreign currency maintained a fixed relation to that of the parent company. If, however, the relative exchange value of the foreign currency should decline substantially, this method of valuation would result in maintaining a value for the investment on the parent company's books much in excess of the amount which could be realized and if the foreign currency did not recover its former value the parent company would be obliged at some time to take up a heavy loss. The danger of this method of valuing foreign investments is apparent when considered in the light of the experience of American companies which made investments in Germany and other European countries in the years 1919 and 1920. In the case of Germany the investments so far as they were represented by current assets became valueless, when the paper currency was replaced by the present currency, and in the case of other countries the values in American currency were substantially decreased when the various currencies were stabilized on a basis considerably below the former exchange value of the currencies. Investments in fixed assets in foreign countries generally are not affected by exchange fluctuations, because in the long run their reproductive cost is adjusted on the basis of gold, particularly in the case of machinery and equipment imported from other countries.

In conclusion it may be stated that a concern engaged in international trade should conduct its business so as to realize normal profits on its foreign operations and should not try to enhance its profits by speculative gains due to fluctuations in foreign-exchange rates. But in order to realize normal profits on foreign business it is necessary to eliminate the effect of foreign-exchange fluctuations as much as possible. As has been shown, this may be accomplished by remitting all profits to the home office at frequent intervals and by keeping the assets in foreign currency at a minimum.

Continuous Audits

By Martin Kortjohn

Leading accountants are of the opinion that the expansion of the accounting profession lies in rendering a more intensive service to an increasing number of appreciative clients. They view with concern the decline of business due to a partial cessation of mergers and consolidations, a shrinkage in cost work and systems assignments, a material reducton in tax work, and the frequent omission of audits because of depressed financial conditions. When the net result for 1931 is a loss, it is hard to convince clients that an audit is essential even if no income tax is due to the government. This scarcity of accounting assignments for the coming year may prove a blessing in disguise.

Before the world war, there was considerable agitation among accountants for continuous audits, or monthly audits, as they were then called, on a yearly-retainer basis. Their principal object at that time was to furnish employment for accountants throughout the year. The natural business year, now so prominently, if not effectively, featured, did not then receive much attention. The best minds in the accounting profession were engaged in converting accounting work from a seasonal occupation to an all-the-year-round activity.

And then came the war and with it the revenue acts of 1917, 1918 and their immediate successors.

The war itself and the revenue acts designed to pay for it provided an abundance of work for accountants, and the agitation for continuous audits was abandoned, at least for a time. Substantial income-tax fees provided income, not only for established accounting offices, but for new and, in some cases, inexperienced practitioners. Cost work and systems work were shunned or relegated to special departments organized for that purpose. Eventually, the various tax tangles were straightened out and, as a result, tax work dwindled.

But by that time there arose a new kind of accounting activity. Some financial and organizing genius began to convince people that if several operating units could be brought under one management and control, miraculous results could be attained. The savings that were to be effected were said to be enormous, and the dividends that were promised stockholders were alluring. Accordingly, many consolidations were arranged and these provided profitable employment for a number of accounting offices, generally the larger ones. Usually, as a net result there were thrown out of employment a few general managers and accounting offices lost a few clients; beyond that the savings were purely imaginary. Few stockholders of merged concerns are now happy.

Whereas income-tax legislation had brought about a desire for accurate accounting and, by the abandonment of ruinous competition, had almost paid for the war, no beneficial results are apparent from the wave of consolidations. It even seems that the enormous profits of the promoters of the various consolidations were fed to the Moloch of speculation in Wall street.

At the present time it would require great eloquence to convince the proprietor of a small business that he should merge with a large unit and accept a position as salaried employee and such dividends as the promoters might care to dole out. People no longer are inspired by mere size, and the proprietor of a small business prefers to remain his own boss and engage the services of a good professional accounting office to render continuous, sound accounting and financial advice. This is supplied where continuous audits are made.

It is common knowledge that, under ordinary present conditions, the larger unit has no advantages in buying or selling which can not be overcome by the smaller operator by personal supervision and close consideration of local conditions. In this matter, accountants experienced in operating problems can be of great value, provided they will keep in close touch with local and general business and management problems. If they keep fully informed and render sound advice, they will earn the respect of the client and, in addition, a substantial yearly fee.

It goes without saying that their views must not be limited to the knowledge required to prepare a balance-sheet for credit purposes. It is their job to help the management earn larger net profit.

An encouraging sign for the future of accountancy is the readiness with which banks accept statements prepared by accountants in good standing regardless of the size of their offices. Banks no longer give preference to statements prepared by offices with branches in every large city; in fact, they prefer those which have had in their preparation the personal attention of the principals, instead of that of a hired accountant in a large office. The closer relationship tends to raise the professional accountants in the esteem of the bankers and the general public and paves the way for their engagement for additional and larger assignments.

Besides, a banker will give special terms to a business which keeps itself well advised and whose policies have the thoughtful consideration of professional accountants. Continuous audits establish a closer relationship than balance-sheets prepared once a year for credit purposes.

Many transactions carry with them grave taxation and other problems if improperly handled. Quite often, accountants are called upon to give opinions on transactions that have been completely consummated, and then find that great savings could have been effected if a slightly different course had been adopted. Ordinarily, it is then too late for correction. If professional accountants with wide public experience were always consulted beforehand, many difficult situations could be averted. Accountants engaged continuously on a yearly retainer can effectively and economically render exactly such a service.

A continuous audit or a monthly check by trained staff accountants will bring to immediate or early notice any unusual items which might give rise to complications or difficulties later. When these develop, the client and the accountants should sit down together and discuss fully the items and their effect on taxation, credit and other phases of the business. If the accountants are on a yearly retainer, clients will have no hesitancy in consulting them freely and fully.

An auditing expense of, let us say, $500 for an annual audit for credit purposes only may be a large expense for a small business, but to pay from $600 to $2,400 a year to have all accounts closely checked each month and to get, in addition, free professional accounting and financial advice whenever needed, is quite another thing. The former may be a mere expense whereas the latter would, in all probability, pay for itself in economies effected or increased efficiency.

Competitors usually like a well advised concern because it offers less chance of ruinous competition. No professional accountants would be guilty of advising sales merely for the purpose of stifling competition. In this way accountants perform a civic duty toward the entire community and truly conserve capital.

It must not be assumed that all the advantages of continuous audits accrue to the clients; on the contrary, accountants are great gainers provided they are properly prepared to handle these services. It is safe to assume that the "every satisfied client recommends another" theory is a fallacy in actual practice. Magazine articles do not give practical advice on how to build up an accounting practice. If the advice there given were followed by the ordinary beginner, he would soon find himself behind in his rent, his family in want and he himself a candidate for employment on the staff of a larger office better managed.

Continuous audits and service offer the means of keeping in close touch with clients and their business associates, employees and friends. "Out of sight, out of mind" is particularly true in accounting practice, and a once-a-year client is not strongly held by the accounting practitioner. A client who must be continually "wooed and won" is not a strong asset in an accounting office. By serving clients continuously, the risk of losing them is reduced to a minimum. Besides, their friends, associates and employees offer a never-failing source of new business for the accountants.

With continuous audits and service, most complaints against the winter rush and the insistent demand for the natural business year disappear. It is true that accounting offices most of whose clients are on a calendar-year basis have considerable extra winter work on closing and the preparation of tax returns, but employees gladly spend a few evenings working if they know that their jobs are safe throughout the remainder of the year.

A great deal of routine work can be done during the less busy season and checking can, in some cases, be completely deferred during the busier months. Under the ideal arrangement for continuous audits and service, the accountants can make their own plans for completing their work on time without an undue strain on the staff. Besides, it is a great assurance to a staff accountant to know that he is not a temporary "fill-in" man.

I doubt if competition is the life of trade; in the accounting profession it certainly gives rise to the most distressing experiences. A young accountant will sometimes, under competition, make unreasonable concessions to unscrupulous clients and come perilously close to compromising his integrity. It is therefore of great importance that he recognize the most effective means of building up a practice in which he can make a comfortable living and retain his full self-respect. The building up of a practice is, in ordinary circumstances, never easy, but the monthly audit and service offers the simplest means to attain his end.

Receivables of Jobbing Concerns

By J. P. Grantham

During the past few years there has been a marked increase in the tendency of jobbing concerns to finance their customers to a considerable degree either through cash advances or the extension of credit for a sufficient amount of merchandise to constitute the normal stock of goods required by the volume of the retailer's business. The reasons for the growth of this custom and the debatable question of economic justification do not fall within the scope of this article, which is concerned merely with the necessity of segregating in the balance-sheet those receivables which, in the ordinary course of business, may be liquidated so as to meet current liabilities and those which are in the nature of more or less permanent advances, as that distinction is of the utmost importance in the financial position of a jobbing concern.

It frequently happens that the extension of an abnormal amount of credit (and sometimes, but less frequently, advances of cash) takes the form of an open account receivable which is later converted into notes, in whole or in part. Such notes are, as a general rule, secured by chattel mortgages on the stock and fixtures and perhaps, too, the personal property of the debtor, assignments of insurance policies, leases, stocks and bonds and the like. If the debtor be a closely owned corporation, it is not uncommon for its capital stock, duly endorsed in blank, to be held as collateral to the notes. In such instances the jobber becomes, to all intents and purposes, the temporary owner of the retailer's business, although not a holder of record.

Notes receivable and the securities held as collateral against them, together with any other securities owned, should be examined at the same time and kept under the control of the auditor until all securities have been checked. The existence of notes out for collection or in process of foreclosure should be confirmed by correspondence with the holders, and the proceeds of those collected since the date of the audit should be traced into the cash records.

Unless the auditor has been instructed to make a surprise examination of the notes and securities the verification will be expedited by having the client's staff prepare lists of the notes on schedules, outlined in advance by the auditor, which call for the following information: name of maker, date of original transaction which gave rise to the note, date of note, maturity, original amount, balance at audit date, interest rate, date to which interest has been paid, amount of accrued or prepaid interest, description of collateral, comments concerning collectibility and estimated reserve required.

From these schedules a summary can be prepared which will show the amount of the secured and unsecured notes of the various classes, such as time loans, demand loans and serial or instalment notes, and the age of each class. It is of the utmost importance that the classification of notes receivable by age be based on the dates of the original transactions which gave rise to the notes rather than on the dates of the notes themselves. Failure to follow this procedure frequently results in an altogether erroneous impression of the receivables, as a substantial portion of the debts may have remained in the form of open accounts for a considerable period prior to the conversion into notes. Moreover, some of the original notes may have been renewed from time to time in whole or in part.

It may be well to point out that the maturity of secured notes, except those due serially, is frequently fixed by jobbers at a date in advance of the time payment or reduction is expected and renewal notes are not accepted, unless the statute of limitations threatens to operate against the original note. This places the jobber in position to institute foreclosure proceedings at any time; moreover, under the laws of some states the holder of an original note is in better position in the event of litigation than the holder of a renewal note.

Notes which have arisen through the practice of financing customers, whether by cash advances or extension of abnormal credit, should generally be regarded as non-current assets and shown separately under some appropriate caption on the balance-sheet. However, there can be no strong objection to including among current assets that portion of such notes which is reasonably certain of collection during the ensuing year. The amount to be so treated must be predicated to a large extent on estimates made by the management, but the aggregate amount of those estimates can be confirmed in a broad way by a comparison with the actual collections on such notes during the year under review, as revealed by an analysis of the notes-receivable controlling account, tempered, of course, by the consideration of current credit conditions in the particular territory.

Whenever practicable the company's staff should prepare for the auditor's use trial balances of the customers' ledgers showing, in columnar form, the age of those accounts which are past due, classified somewhat as follows: 30 to 60 days past due; 60 to 90 days past due; 90 to 180 days past due; over 180 days past due. However, it is not uncommon to find the open balances so numerous as to render it impracticable to attempt to list and age each of the accounts. In such instances, it will usually suffice to confine the trial balances of each ledger to adding machine tapes and to determine the age of the total outstanding accounts in the following manner:

List and age all the larger accounts; i.e., those having balances in excess of a specified amount. While these are apt to be relatively few in number, they will probably aggregate a substantial portion of the total amount outstanding.

List and age a representative number of accounts, selected entirely at random, having fairly large balances, the same number having medium sized balances and the same number having small balances.

The remainder of the amount outstanding can then be aged by the application of the percentages revealed by the analysis of the accounts selected entirely at random.

This method will usually be found to yield substantially accurate results, provided, of course, that all open balances which have arisen through the practice of financing customers have first been eliminated from the aggregate amount outstanding.

In some instances it is desirable, if not essential, for the auditor to verify in detail the trial balances of all customers' ledgers as well as the age of the accounts, but this work may often be confined, with perfect propriety, to a representative number of the ledgers. The auditor must use judgment in determining which of the two methods to follow and his decision should depend in part upon the nature of the business and other considerations, but primarily upon the efficacy of the company's system of internal check.

In either event, he must be fully informed as to the company's credit terms and must watch particularly for accounts representing advances of a more or less permanent nature, consignment accounts, special terms (such as future dating and "pay-on-reorder") and for any notations which may appear on the ledger sheets indicating that the customer has been placed on a C. O. D. basis or that the account has been turned over to attorneys for collection. The composition of the balances should also be observed, as it sometimes happens that, while a customer may be making regular payments on his current account, items which are in dispute have been carried forward.

The authenticity of charges and credits to customers' accounts should be tested by reference to copies of invoices and shipping records, the cash receipts book or remittance advices and, more particularly, evidence of approval, by a responsible officer, of credits representing allowances for one reason or another.

Consignment accounts clearly have no place in accounts receivable as the merchandise represented remains the property of the consignor and is held at its risk until sold and should, therefore, be reflected in its inventory at cost and not in its receivables at selling price. It may be added that true consignment accounts are relatively rare and that merchandise sold on a "pay-on-reorder" basis (which is merely an extension of normal credit terms with, as a rule, the right to return) is frequently mistaken for consigned merchandise.

If a sufficient length of time has elapsed since the date of the balance-sheet to allow a substantial amount of collections to be made, the amounts collected should be indicated on the schedules. The auditor will then know approximately the amount of uncollected accounts still remaining on the books and, when discussing the past due accounts with the credit manager, can eliminate those which have been collected.

The determination of adequate reserves for doubtful receivables, discounts, returns and allowances is of utmost importance in the audit of a wholesale jobbing concern. These reserves, while usually shown in the balance-sheet in one amount, are generally carried on the books in different accounts and the verification of them must proceed along different lines.

Each note or series of notes should be discussed individually in order to determine the reserve required for probable losses. In the case of secured notes, consideration must be given to the value of the collateral underlying the notes, if that can be ascertained with any degree of accuracy, bearing in mind the cost of realizing that collateral. If the collateral consists of a mortgage on the stock of merchandise sold the customer, it must be remembered that the basis of valuation of that merchandise should be cost to the jobber, not selling price, less an allowance to provide for slow-moving, obsolete and shop-worn items. In the case of fixtures which must be repossessed, the resale value to the jobber, less the cost of repossession, must govern.

After the accounts receivable have been properly verified and aged, the auditor should decide upon a method to use in order to determine the amount of receivables upon which losses may be sustained and the approximate amount of such losses. If the number of accounts is not unduly large each past-due account may be discussed with the credit manager and the estimated loss determined. If, on the other hand, the accounts are very numerous, the auditor must adopt a method of procedure which will give him sufficient information to enable him to determine an adequate reserve without too great an expenditure of time. One such method which may be followed to advantage requires the preparation of (1) a list of the balances due by the principal trade debtors and (2) a list of the past-due balances over a specified amount. As mentioned above, it will usually be found, in the case of a jobbing concern, that the balances due by a comparatively small number of customers will comprise a substantial portion of the outstanding receivables and a detailed discussion of these balances, which comprise the first list, will bring to light any doubtful items included in it.

Considerable care must be used in determining the amount of the balances to be entered on the second list. If the limit is set too low, many accounts will be listed and considerable time spent discussing trifling balances, thus defeating the purpose of this method of procedure. If it is set too high the list will not be representative of the accounts in general. The auditor must, therefore, fix an amount which will eliminate from discussion numerous small balances but will be small enough to allow a representative portion of the balances to be listed for discussion. After the accounts included in the second list have been discussed and it is found that, say, 60% in amount of the total receivables (other than those included in the first list) have been listed, it is reasonable to assume that the specific reserve for doubtful items determined by this discussion represents 60% of the total specific reserve required against all but those accounts included in the first list. The amounts due from the principal debtors, together with the specific reserves required against those amounts, should be eliminated from any computations on percentage bases, lest the results be distorted.

In addition to the specific reserve for doubtful items there must also be a general reserve to take care of losses which, due to unforeseen circumstances, will ultimately be sustained on accounts that are apparently good at the time of discussion. The amount of this general reserve may be determined with reasonable accuracy, if current credit conditions are normal, in the light of the company's known bad-debt experience.

Determination of the average percentage of bad debts to net sales requires an analysis of bad debts charged off during, say, the past four years, classified as between the years in which the balances originated, and, also, the classification as between years of origin of the specific reserves estimated to be required for receivables remaining on the books at the date of audit. For example, if the reserve is to be determined at December 31, 1931, the losses from receivables which originated in the years 1928, 1929 and 1930, whether actually sustained and written off prior to December 31, 1931, or still carried on the books at that date and specifically protected by reserves, can be approximated with reasonable accuracy; that is to say, if the business placed on the books prior to December 31, 1930, has not been paid for or definitely ascertained to be uncollectible and written off as such by December 31, 1931, it ought not to be difficult to estimate fairly accurately the loss which will ultimately be sustained on that business. However, the aggregate losses which will ultimately be sustained on the business placed on the books in the year 1931 would, at December 31st of that year, still be largely a matter of conjecture, and for that reason the figures relating to the business originating in 1931 are eliminated from the following table, which is used to compute the average bad-debt experience for the three years preceding the one under review:

	Year 1928	Year 1929	Year 1930	Total for the three years
1. Net sales	$	$	$	
2. Bad debts charged off from January 1, 1928, to December 31, 1931, which resulted from transactions originating in the respective years	$	$	$	
3. Portion of reserve for doubtful receivables remaining on the books at December 31, 1931,				

which is attributable to transactions originating in the respective years..........................	____	____	____	____
4. Together (2 plus 3)..............	$____	$____	$____	____
5. Percentage of net sales (4 divided by 1)........................	%	%	%	%

Having obtained the foregoing information, the aggregate reserve required for bad debts can be expressed in the following table:

(1) Total specific reserves required for doubtful receivables remaining on the books at December 31, 1931, as determined by discussion of the open balances...		$
(2) Add—general reserve for sales made during the year ending December 31, 1931, determined by the application to net sales of the average percentage of bad-debts losses for the preceding years as revealed by the foregoing table............................		____
Together..................................		
Deduct—		
(3) Amount of specific reserves for doubtful receivables that originated in the year 1931, which is included in item (1) above..........................	$	
(4) Amount of bad debts charged off during the year 1931, which arose from transactions originating in that year..............................	____	____
Balance, being the reserve required at December 31, 1931..................................		$____

In case the reasons for deducting items (3) and (4) are not clear, it may be well to repeat that the aggregate losses which will ultimately be sustained from business placed on the books in 1931 will be difficult to determine at December 31st of that year. Consequently, both the known and estimated portion of those losses have been replaced, in determining the total reserve required at December 31, 1931, by item (2) in the table, which provides for all losses to be sustained on that year's business at the average rate of the losses for the three preceding years, which are known with much more accuracy. It is obvious, of course, that if abnormal credit conditions prevail in the current year or any of the three preceding years, the procedure outlined will have to be modified by consideration of those abnormal conditions.

In addition to the reserve for doubtful receivables, reserves should be provided for discounts, returns and allowances. These can best be determined in the light of the company's past experience with respect to each, but the computations should be based on gross sales, as the outstanding accounts against which the reserves are required are stated at gross selling prices. The provision for losses on expected returns should, of course, be limited to the gross profit taken up when the merchandise was sold if the merchandise to be returned is in salable condition.

It can not be emphasized too strongly that the current position of a jobbing concern is of primary importance and that the receivables and related reserves have a vital bearing on that position. Since the determination of the approximate realizable value of the receivables and their availability to meet current obligations is, of necessity, very largely a matter of judgment, supplemented by a knowledge of the company's past experience and of current credit conditions, it is incumbent on the auditor to bring to bear on the problem all the skill, diligence and ingenuity of which he is capable.

Grain Futures and Grain Accounting

By Alexander M. Field

In order to facilitate the marketing of grain and other staple commodities, to promote business standards and procedures, to advance the interest of members by the acquisition and dissemination of essential commercial information and for other purposes, produce exchanges have been organized in various sections of the country.

The exchanges neither buy nor sell commodities. These functions are reserved for members, who trade on their own behalf or as commission merchants or brokers for others. The most important grain exchange in the United States is the Chicago board of trade and its customs and practices are more or less typical of the others. Exchange rules or regulations mentioned in this article are those of the Chicago board of trade.

A member, in addition to trading in grain on his own behalf and for others, may operate owned or leased elevators or warehouses for the purpose of carrying (a) his own supplies or (b) stocks of customers. In the latter case he acts as custodian. The principal sources of revenue from these combined operations are generally reflected in the following accounts:

(a) Profit or loss from grain merchandising,
(b) Commission and brokerage,
(c) Elevation and storage.

The term grain, as defined by the board of trade, comprises wheat, corn, oats, rye, barley and flaxseed, and it is desirable that separate income accounts for each of these grains be carried under the main general revenue accounts mentioned above. The commission and brokerage and the elevation and storage accounts, however, are not always segregated as to grains.

There are two distinct grain markets on the exchange, the "spot" and "futures." The latter is by far the more active. "Spot grain" is defined by the Chicago board as grain in the Chicago district, subject to sale for immediate delivery. A substantial volume of trading transactions is carried on through the exchange in spot or cash grain, but as such trades may also be consummated through direct contact with the farmer, the miller or exporter, the "spot market" is more or less decentralized. The "futures market," on the contrary, is highly centralized and buying and selling orders from all over the world are consummated on the exchanges, where the quoted prices generally adjust themselves to a world parity.

The "futures" market is extremely sensitive, trading is highly competitive and prices are influenced from day to day by changing conditions and developments. Statistics are available relative to the visible supply of grain, crop prospects, etc., but other important factors affecting ultimate prices are either unknown or uncertain. The consumption demand for the crops is more or less stable and can be estimated with a reasonable degree of safety, but prognostications relative to the future supply can only be cautiously accepted, as such forecasts may be completely upset by weather and other changeable and unknown factors.

The sensitiveness of the futures market to changing crop prospects and the facility with which "trades" can be closed make it attractive for speculative operations. The speculators in seeking profits from buying and selling without the necessity of handling the commodities take the risks inherent in this kind of trading and thereby provide an opportunity to owners of grain to acquire through "hedging" operations the insurance against price changes on the grain which they expect to sell or use in manufacturing processes.

In nearly all transactions which involve a purchase for resale, whether the commodity acquired be disposed of without change or in a converted form, there exists an element of speculation. The exception to the general rule occurs when the buyer of a commodity simultaneously sells it, but such transactions are rare in the general run of a manufacturing or merchandise business, and in most trading in commodities there is a lapse of time between the purchasing and selling dates. During this interval the market price of the commodity may advance or recede and, to the extent of the change in the market price, the results from trading operations are likely to be affected favorably or adversely.

This factor of speculation in commodities in general is more or less recognized in the commonly accepted basis of valuation (cost or market, whichever is lower) for inventories and purchase commitments, and the reduction of inventories to market, if lower than cost, is an acceptance of the known speculative loss on the commodities held at the date of the revaluation.

The speculative hazard attaching to the ownership of goods varies with different classes of commodities and assumes greater importance when the goods are subject to almost continuous price changes. The market quotations for grain are in a perpetual state of fluctuation and, to protect themselves against the speculative risks incident to this condition, owners and users of grain have adopted the policy of "hedging" their merchandising transactions.

"Hedging" consists of a simultaneous purchase and sale in the two markets ("spot" and "futures") which are expected to act in like manner, so that a gain in one will be offset by a corresponding loss in the other, or vice versa. In order to illustrate a simple hedge, the following hypothetical transactions may be assumed:

(1) A grain company purchases 5,000 bushels *spot* wheat at $1.00 a bushel and at the same time sells 5,000 bushels in the *futures* market at, say, $1.02 a bushel.

(2) The grain company subsequently sells the 5,000 bushels of *spot* wheat at 98 cents a bushel and simultaneously buys 5,000 bushels in the *futures* market at, say, $1.00 a bushel, thereby closing its futures trade.

In this case, if the expectation that the two markets will move equally in the same direction is correct, the price at which the company effects its futures purchase should be $1.00 a bushel and the loss of 2 cents a bushel on the spot grain will be compensated by a like gain on the futures transaction. Actually, the two markets may not be affected equally, but generally they move in the same direction, and the grain company is at least relieved of the greater part of the risk attaching to price instability.

In these circumstances, it may appear that the grain company makes no profit, but this is true only in so far as profits arising from price changes are concerned. The market prices for grain are for a specified grade and, as the quality sold and delivered varies from the specified grade, a premium or discount differential is realized. The purchases by the grain dealer, though varying in quality, may be treated and regarded so that the poorer grades purchased may realize a better price than would be possible if they were sold without regrading.

The elimination of the speculative risks attaching to price changes enables the grain company to conduct its trading on a much smaller margin than would otherwise be possible, and, in addition, the company secures the advantage, through price stabilization, of being placed in a much stronger position when seeking credit. Banks and other lenders of money are better protected when the grain covered by the warehouse receipts deposited as collateral to the loan is "hedged." It will be evident, therefore, that a grain company should at all times be completely "hedged," and any departure from this procedure places it in a speculative position.

Trading in the futures grain market, whether it be for speculation or for hedging purposes, contemplates delivery of the quantity sold at a future date and at a fixed price. The contract is a basis contract, but the seller has the option to deliver a better or poorer grade with a price premium or discount differential. In actual practice, of course, physical delivery on all trades is unnecessary and is not effected, because before the delivery date the same quantities may be sold and purchased a number of times, thereby cancelling many of the trades.

All contracts on the Chicago board of trade made by members on their own behalf or for others must be cleared through the clearing house and all contracts are subject to its rules and regulations. These regulations require members to file at the close of each day clearing sheets on which are recorded all trades made during the day, as well as the trades carried over from the preceding day. The open items must also be brought to the closing market price of the day and should be grouped by commodities and by delivery months. Only such trades as are not offset are carried forward to the clearing sheet of the following day. If a member buys any amount of a certain commodity for delivery in a particular month and subsequently sells any amount of the same commodity for delivery in the same month, the subsequent sale is considered an offset to the purchase and only the variation in the quantities purchased and sold is considered as an open trade. Likewise, a sale would be offset against a subsequent purchase. This rule is of distinct advantage to the members, as they are required to deposit margins on open trades and the practice of offsetting trades reduces the required margins. The shares of capital stock of the Clearing House Corporation held "in pledge" by the clearing house on behalf of the members are credited against margin calls to the extent of the last established book value of such shares.

A settlement on all trades cleared is effected between the clearing house and the clearing members, sellers and buyers, at the end of each day. On the day the *futures* contract is made, the difference between the contract price and the final market price of that day is settled through the clearing house, and thereafter, on each day until the trade is closed, an adjustment is made to bring the trade to the final market price. Thus, if A sold B futures of 5,000 bushels of wheat on July 1st at a price of $1.00 a bushel and the final market price for that date was $1.01 a bushel, A would pay the clearing house by cheque the difference of $.01 a bushel, or a total of $50.00, and the clearing house in turn would pay B by cheque the sum of $50.00. If the final market price was less than the contract price, the differential would be paid by the clearing house to A and that institution would receive an equivalent amount from B. Such settlements would continue daily until the trade was closed. The adjustments subsequent to the first one would be on the basis of the differential between the final market prices of the successive days.

If a trade is closed by delivery of the grain, the delivery is made on the basis of the final market price of the preceding day.

To revert to the hypothetical transactions given above, let it be assumed that (1) A delivers the 5,000 bushels of wheat to B on July 6th, (2) the final market price showed an advance of $.01 a bushel on each day the contract remained open, and (3) all intervening days were legal trading days, the effect of the settlements on the accounts of A would be as follows:

July 1–5 Debit loss or gain on futures	$ 250.00	
Credit Cash		$ 250.00
To record the payments to the clearing house of $50.00 daily from July 1 to July 5, inclusive, in adjustment of the contract price of $1.00 a bushel on 5,000 bushels of wheat to the final market price of each day.		
July 6 Debit cash	$5,250.00	
Credit wheat sales		$5,250.00
To record the delivery to B on July 6 of 5,000 bushels of wheat at the final market price of $1.05 a bushel on July 5, sold under contract on July 1 at $1.00 a bushel.		

In this example the actual trading profit or loss of A would be determined as follows:

Wheat sales at closing price of $1.05 July 5	$5,250.00
Less—Loss on futures	250.00
Wheat sales at contract price of $1.00 a bushel	$5,000.00

Cost of wheat sold	?
Gain or loss	?

If A sold his 5,000 bushels of wheat on the "spot market" and closed his futures trade by a purchase of an equivalent amount, the result would vary only to the extent of any difference in the price of the spot sale and the contract futures sale.

The settlements referred to above are made solely between the clearing members and the clearing house; the customers of the clearing members are not directly concerned with the daily adjustments. Thus, if a grain company is acting as a commission house, the accounts of the customers would not be adjusted daily to give effect to the settlements on the trades of the customers. As a matter of business prudence, however, the customers of the grain company should be adequately margined at all times and the margin records of the company should be adjusted each day to reflect (a) the changes in market prices on the customers' trades, and (b) the effect of the changes on the margin position. As and when the customer is charged or credited with his loss or gain the account for loss or gain on futures account will be relieved.

The accounts of a grain company are not exceptionally complicated, but numerous warehouse and financial records have to be maintained, and they require considerable clerical and accounting work. The members of the exchanges are required to comply with the rules and regulations of these associations and certain prescribed forms have to be used. In addition, governmental regulations relative to futures contracts, warehousing of grain, etc., must be observed. All these things necessitate the keeping of books and records in considerable detail.

A description of the records within the limits of an article of this kind is impracticable, but a few brief comments on the principal items appearing on the financial statements and the methods of verification employed in an audit may prove of interest.

Grain is bought and sold for cash, and accounts receivable and accounts payable do not arise from these trading transactions. If the company is in the commission business, there will probably be balances due to or from customers. The trading transactions of the customers should be adequately margined and confirmations of the amounts on deposit, as well as the trading position, should be requested from the customers as of the close of the fiscal period. For balance-sheet and profit-and-loss purposes, the trades of the customers should be brought to the final market price and any profit or loss disclosed thereby should be credited or charged to the customers' accounts. The contra entries should be to loss or gain on futures. These adjustments are necessary because, as stated previously, the daily settlements effected by the company with the clearing house are not recorded in the customers' accounts but are taken up through the cash account and the loss or gain on futures.

In addition to the accounts receivable referred to above, there may be accrued storage or warehousing fees on grain due from customers and as these charges are computed on (a) the quantities in storage, (b) the period of time in storage and (c) a specified storage rate, the accuracy of the accruals is readily verified.

The quantities of grain in the inventory are generally ascertained from elevator or warehouse records and substantiated by estimates made by superintendents or other responsible employees. These elevator or warehouse records should be adjusted periodically by the company with respect to any overages or shortages disclosed by "weigh-overs" or "clean-ups." The stocks stored in warehouses other than those operated by the company should be evidenced by warehouse receipts or certificates obtained from the public custodians. The quantities shown by the inventories, after adding the undelivered purchases of "spot" grain and deducting the undelivered sales of "spot" grain, should, if the company is not in a speculative position, be in approximate agreement with the open trades in the "futures" market. A summarization of the market position of a company (quantities assumed for illustration) would be as follows:

	Bushels
Wheat in elevators or warehouses	1,250,000
Open spot purchases, viz., grain in transit or to be shipped on specified dates at specified prices	50,000
Together	1,300,000
Less—Open spot sales, shipments to be made on specified dates at specified prices	30,000
Balance	1,270,000
Open "futures" sales	1,270,000

The reason for the inclusion of the open "spot" purchases and open "spot" sales in the foregoing tabulation is that when these transactions are undertaken, simultaneous sales and purchases are made by the company in the "futures" market. Similar tabulations should be made of the other grains comprising the inventory.

The pricing of the inventory should be on the basis of the final market price of the close of the fiscal period, and no consideration need be given to cost. The justification for this is derived from the "hedging" operations which provide insurance against price changes. The futures transactions represented by open trades are, as stated previously, adjusted to the final market of each day, and, inasmuch as the aggregate quantities in the open futures contracts should approximate the total quantities in the inventories, it naturally follows that any loss or gain in the futures will be offset by a gain or loss on the inventories when priced at market. Thus, if the inventory consisted of 5,000 bushels of wheat at a cost of $1.00 a bushel, and the final market price on the day of the inventory was $1.02 a bushel, there would be an apparent gain on the inventory of $.02 a bushel or a total of $100. The company, however, when it purchased the grain, immediately sold a like quantity in the futures market, and, assuming that the two markets have been equally affected, the futures transaction shows a loss of $100. The effect on the accounts of the company will be as follows:

(1) Inventories are increased $100 as a result of revaluation.
(2) Cash is reduced $100 as a result of settlements on open futures.
(3) Profit-and-loss is credited with a gain of $100 arising from inventory revaluation.
(4) Profit-and-loss is charged with a loss of $100 on open futures.

The inventory stocks should, of course, be graded, and price differentials should be applied in accordance with the quality.

The cost of all open purchase commitments of cash grain should be ascertained, and any difference between the cost and the final market price of the date of the balance-sheet should be taken up through the inventories and the profit-and-loss accounts. These transactions are "hedged," and, as stated previously, adjustments are made daily. Likewise as the "hedge" on open spot sales is removed as of the date the sales are consummated, open sales should be valued on the basis of selling prices. The sales will not be reflected on the books until shipments are effected.

In closing the profit-and-loss account, the loss or gain on futures should be transferred to the profit or loss from grain merchandising, so that the actual trading profit may be ascertained. The commission and brokerage income will fluctuate with trading activity. Elevator and storage income should increase with abundant supplies of grain.

The unusual features of the balance-sheet have been described. Such assets and liabilities as are not specifically mentioned generally present no characteristics uncommon to other kinds of business. The comments have been confined solely to problems relating to the transactions of grain brokers and do not deal, except indirectly, with the grain transactions of milling companies and others.

Students' Department

H. P. Baumann, *Editor*

AMERICAN INSTITUTE EXAMINATIONS

[Note.—The fact that these solutions appear in The Journal of Accountancy should not cause the reader to assume that they are the official solutions of the board of examiners. They represent merely the opinions of the editor of the *Students' Department.*]

Examination in Accounting Theory and Practice—Part I

November 12, 1931, 1:30 P. M. to 6:30 P. M.

The candidate must answer the first three questions and one other question:

No. 3 (35 points):

Explanatory Notes

A logging company buys timberland (standing timber), cuts it down, saws it into logs and sells the logs.

The timber is first "cruised" by an expert, who reports upon the approximate amount and condition of each kind of timber on each section.

The land may be sold for a lump sum, at so much per acre or so much per thousand feet logged.

Where the land is close to a river, the skidroad process is employed; if too far away from a river, railroads are built. Frequently, the combination process is used.

When a section "goes under the axe," a camp is built, a road cleared and skidroad or railroad, or both, constructed. The cost is spread over the section cleared, as such equipment is worthless when this particular part is exhausted.

The processes employed are felling, bucking (sawing into logs), branding (a different mark being used for each section), logging and hauling—over skidroad, by railroad to landing on river bank, or direct to the mill. If the logs are dumped into a river, a boom, owned generally by an outsider, is necessary for sorting.

The logs, rafted or railroaded to the mill, are then graded and measured by both owner and buyer. As soon as the content of either raft or car is determined, the mill sends the owner (logger) a credit memorandum for it.

Problem

From the following trial balance and explanatory data, prepare
(a) Balance-sheet, as of December 31, 1930.
(b) Statement of operating cost for the year ended December 31, 1930.
(c) Statement of profit and loss for the same period.

Samoset Logging Company—Camp No. 1
Trial balance—December 31, 1930

	Dr.	Cr.
Cash in bank	$422,500	
Petty cash	1,750	
Accounts receivable	165,450	
Inventories:		
Cook-house	250	
Wangan*	150	
Standing timber (stumpage)	157,800	
Clearing cost	2,400	
Machinery and equipment	22,400	
Tools	1,250	
Cable	8,200	
Skidroads	29,000	
Office fixtures	1,500	

* Wangan—A flatboat used by Maine lumbermen for transporting their tools and provisions.

	Dr.	Cr.
Notes payable		$ 50,000
Accounts payable		18,750
Payrolls accrued		37,100
Bonds—6 per cent		100,000
Capital stock		500,000
Labor	$59,400	
Rigging maintenance	4,850	
Sundry operating expenses	900	
Cook-house purchases	12,350	
Cook-house sales		15,250
Wangan purchases	1,210	
Wangan sales		1,320
Log sales		185,200
Salaries—administrative	10,000	
Office expenses	2,550	
Sundry expenses—general	710	
Bond interest	3,000	
	$907,620	$907,620

A survey of the situation, and an analysis of the records, produced the following information:

(1) There was no inventory of logs on hand, January 1, 1930, either in wood or in water.
(2) The cruiser's estimate of the tract contents was 60,000,000 feet.
(3) During the year, 26,040,000 feet were logged and 25,470,000 feet were rigged (placed in heaps or piles).
(4) Inventories, December 31, 1930, were:

Cook-house	$ 300
Wangan	160
Logs in water	2,320,000 feet

(5) Logs sold, 23,150,000 feet.
(6) Labor account was analyzed as follows:

Felling and bucking	$17,100
Rigging	36,550
Cook-house	3,540
Wangan	2,210
	$59,400

(7) Bond interest is payable semi-annually, July 1st and January 1st, and the dividend declared is 3 per cent.

The brand used in this instance was S L—1.

Fixed assets are to be written off in proportion to footage handled. Equipment depreciation is to be considered as a general expense. Tools are to be written off to felling and bucking, and cable wear-and-tear to rigging.

Solution:

This problem is subject to several different solutions, depending upon the treatment of such items as the net cost of operating the wangan and cook-house, the depreciation on the machinery and equipment, and the difference of 570,000 feet of logs cut, but not rigged.

In this solution, the net cost of operating the wangan and the cook-house is considered as an operating cost, although it may be assumed to be applicable to the entire operations of the camp, including sales and administration.

The depreciation on machinery and equipment is treated as a general expense, as the problem states that "equipment depreciation is to be considered as a general expense." It is possible that some candidates would ignore the requirement of the examiners and apply the depreciation on this asset to the cost of operations.

Under (3), it will be noted that of the 26,040,000 feet logged during the year, 25,470,000 feet were rigged (placed in heaps or piles). In the following solution, the difference of 570,000 feet is shown as an inventory of logs felled and bucked—that is, cut, but not placed in heaps or piles. It is possible that some candidates will consider these 570,000 feet as waste.

Explanatory Adjustments

(1)

Labor:		
Felling and bucking	$17,100.00	
Rigging	36,550.00	
Cook-house	3,540.00	
Wangan	2,210.00	
Labor		$59,400.00
To distribute the labor account.		

(2)

Bond interest	3,000.00	
Bond interest accrued		3,000.00
To set up the accrued liability for bond interest coupons due January 1, 1931, of 3% on the $100,000 bonds outstanding at December 31, 1931.		

(3)

Surplus	15,000.00	
Dividends payable		15,000.00
To record the declaration of the 3% dividend on the $500,000 of capital stock outstanding.		

(4)

Depreciation:		
Tools	542.50	
Cables	3,480.90	
Skidroads	12,310.50	
Machinery and equipment	8,642.67	
Office furniture and fixtures	578.75	
Reserves for depreciation:		
Tools		542.50
Cables		3,480.90
Skidroads		12,310.50
Machinery and equipment		8,642.67
Office furniture and fixtures		578.75
To set aside depreciation for the year on the basis of logs handled.		

The problem requires that the fixed assets be written off in proportion to the footage handled. The depreciation to be charged for the year is, therefore,

	Total cost of 60,000M feet	Footage handled	Proportion	Depreciation
Tools	$ 1,250.00	26,040M	43.4%	$ 542.50
Cables	8,200.00	25,470M	42.45%	3,480.90
Skidroads	29,000.00	25,470M	42.45%	12,310.50
Machinery and equipment	22,400.00	23,150M	38.583%	8,642.67
Office furniture and fixtures	1,500.00	23,150M	38.583%	578.75

It should be noted in the solution that the depreciation on the machinery and equipment of $8,642.67 is considered as a general expense in the profit-and-loss statement as required by the problem. It would seem that this depreciation should be treated as a cost.

(5)

Stumpage used	$68,485.20	
Clearing cost amortized	1,041.60	
Standing timber (stumpage)		$68,485.20
Clearing cost		1,041.60

To charge operations with the proportion of stumpage and clearing cost used during the year on the basis of logs cut.

	Total cost (60,000M ft.)	Cost of logs cut (26,040M ft.)
Stumpage	$157,800.00	$68,485.20
Clearing cost	2,400.00	1,041.60

(6)

Inventory of logs—felled and bucked	1,908.08	
Inventory of logs—in water	13,301.75	
Cost of operations		15,209.83

To set up the inventories of logs felled and bucked, and in water (exhibit C).

(7)

Cost of operating wangan	2,090.00	
Wangan sales	1,320.00	
Inventory—wangan—December 31, 1930	160.00	
Inventory—January 1, 1930		150.00
Purchases		1,210.00
Labor		2,210.00

To record the net cost of operating the wangan for the year 1930 (schedule I).

SAMOSET LOGGING COMPANY—CAMP NO. 1
Working papers—December 31, 1930

	Trial balance December 31, 1930		Adjustments		Cost of operations	Profit and loss		Balance-sheet	
Cash in bank	$422,500.00							$422,500.00	
Petty cash	1,750.00							1,750.00	
Accounts receivable	165,450.00							165,450.00	
Inventory—cook-house	250.00		(8)$ 300.00	(8) $ 250.00				300.00	
Inventory—wangan	150.00		(7) 160.00	(7) 150.00				160.00	
Standing timber (stumpage)	157,800.00			(5) 68,485.20				89,314.80	
Clearing cost	2,400.00			(5) 1,041.60				1,358.40	
Machinery and equipment	22,400.00							22,400.00	
Tools	1,250.00							1,250.00	
Cables	8,200.00							8,200.00	
Skidroads	29,000.00							29,000.00	
Office fixtures	1,500.00							1,500.00	
Notes payable		$ 50,000.00							$ 50,000.00
Accounts payable		18,750.00							18,750.00
Payrolls accrued		37,100.00							37,100.00
Bonds—6%		100,000.00							100,000.00
Capital stock		500,000.00							500,000.00
Labor	59,400.00			(1) 59,400.00					
Rigging maintenance	4,850.00				$ 4,850.00				
Sundry operating expenses	900.00				900.00				
Cook-house purchases	12,350.00			(8) 12,350.00					
Cook-house sales		15,250.00	(8) 15,250.00						
Wangan purchases	1,210.00			(7) 1,210.00					
Wangan sales		1,320.00	(7) 1,320.00						
Log sales		185,200.00					$185,200.00		
Salaries—administrative	10,000.00					$ 10,000.00			
Office expenses	2,550.00					2,550.00			
Sundry expenses—general	710.00					710.00			
Bond interest	3,000.00		(2) 3,000.00			6,000.00			
	$907,620.00	$907,620.00							

Labor:										
Felling and bucking . . .	(1)	17,100.00			17,100.00					
Rigging	(1)	36,550.00			36,550.00					
Cook-house	(1)	3,540.00	(8)	3,540.00						
Wangan	(1)	2,210.00	(7)	2,210.00						
Bond Interest accrued . . .			(2)	3,000.00						3,000.00
Inventory of logs—felled and bucked	(6)	1,908.08							1,908.08	
Inventory of logs in water	(6)	13,301.75							13,301.75	
Dividends payable			(7)	15,000.00						15,000.00
Cost of operating wangan	(7)	2,090.00			2,090.00					
Cost of operating cook-house	(8)	590.00			590.00					
Depreciation:										
Tools	(4)	542.50			542.50					
Cables	(4)	3,480.90			3,480.90					
Skidroads	(4)	12,310.50			12,310.50					
Machinery and equipment	(4)	8,642.67					8,642.67			
Office furniture and fixtures	(4)	578.75					578.75			
Reserves for depreciation:										
Tools			(4)	542.50						542.50
Cables			(4)	3,480.90						3,480.90
Skidroads			(4)	12,310.50						12,310.50
Machinery and equipment			(4)	8,642.67						8,642.67
Office furniture and fixtures			(4)	578.75						578.75
Stumpage used	(5)	68,485.20			68,485.20					
Clearing cost amortized . .	(5)	1,041.60			1,041.60					
Cost of operations			(6)	15,209.83		{ $15,209.83	132,730.87			
						{ 132,730.87				
Profit and loss (surplus) . .	(3)	15,000.00					23,987.71			8,987.71
Total		$207,401.95		$207,401.95	$147,940.70	$147,940.70	$185,200.00	$185,200.00	$758,393.03	$758,393.03

(8)

Cost of operating cook-house	$ 590.00	
Cook-house sales	15,250.00	
Inventory—cook-house	300.00	
Inventory—January 1, 1930		$ 250.00
Purchases		12,350.00
Labor		3,540.00
To record the cost of operating the cook-house for the year 1930 (schedule II).		

Schedule I

SAMOSET LOGGING COMPANY—CAMP NO. 1

Statement of cost of operating wangan for the year ended December 31, 1930

Materials and supplies:		
Inventory—January 1, 1930	$ 150.00	
Purchases	1,210.00	
Total	$ 1,360.00	
Less—inventory, December 31, 1930	160.00	
Materials and supplies used		$ 1,200.00
Labor		2,210.00
Total cost		$ 3,410.00
Less—wangan sales		1,320.00
Cost of operating wangan		$ 2,090.00

Schedule II

STATEMENT OF COST OF OPERATING COOK-HOUSE

For the year ended December 31, 1930

Materials and supplies:		
Inventory, January 1, 1930	$ 250.00	
Purchases	12,350.00	
Total	$12,600.00	
Less—inventory, December 31, 1930	300.00	
Materials and supplies used		$12,300.00
Labor		3,540.00
Total cost		$15,840.00
Less—cook-house sales		15,250.00
Cost of operating cook-house		$ 590.00

Exhibit A

SAMOSET LOGGING COMPANY—CAMP NO. 1

Balance-sheet—December 31, 1930

Assets

Current assets:				
Cash:				
In bank		$422,500.00		
Petty cash		1,750.00		
			$424,250.00	
Accounts receivable			165,450.00	
Inventories:				
Logs—felled and bucked		$ 1,908.08		
Logs—in water		13,301.75		
Cook-house		300.00		
Wangan		160.00		
			15,669.83	
				$605,369.83
Standing timber:				
Stumpage			$ 89,314.80	
Clearing cost			1,358.40	
				90,673.20
Fixed assets:				
	Cost	Reserve for Depreciation	Depreciated Value	
Machinery and equipment	$ 22,400.00	$ 8,642.67	$ 13,757.33	
Tools	1,250.00	542.50	707.50	
Cable	8,200.00	3,480.90	4,719.10	
Skidroads	29,000.00	12,310.50	16,689.50	
Office fixtures	1,500.00	578.75	921.25	
	$62,350.00	$ 25,555.32	$ 36,794.68	36,794.68
				$732,837.71

Liabilities and net worth

Current liabilities:		
Notes payable	$ 50,000.00	
Accounts payable	18,750.00	
Payrolls accrued	37,100.00	
Bond interest accrued	3,000.00	
Dividends payable	15,000.00	
		123,850.00
Bonds—6 per cent.		100,000.00

Net worth:			
Capital stock		$500,000.00	
Surplus—net profit for the year 1930, before provision for federal income taxes	$ 23,987.71		
Dividends paid	15,000.00	8,987.71	508,987.71
			$732,837.71

Exhibit B

SAMOSET LOGGING COMPANY—CAMP NO. 1

Statement of profit and loss for the year ended December 31, 1930

		Amount	Per thousand feet
Sales (23,150M feet)		$ 185,200.00	$8.000
Cost of sales (exhibit C)		132,730.87	5.734
Gross profit on sales		$ 52,469.13	$2.266
Deduct expenses:			
Salaries—administrative	$10,000.00		$ .432
Office expenses	2,550.00		.110
Sundry expenses—general	710.00		.031
Depreciation—equipment	8,642.67		.373
Depreciation—office fixtures	578.75		.025
Total expenses		22,481.42	$ .971
Net profit from operations		$ 29,987.71	$1.295
Deduct—bond interest		6,000.00	.259
Net profit for the year before provision for federal income taxes		$ 23,987.71	$1.036

Exhibit C

SAMOSET LOGGING COMPANY—CAMP NO. 1

Statement of operating cost for the year ended December 31, 1930

	Quantity	Amount	Per thousand feet
Cost of logs felled and bucked:			
Stumpage	26,040M	$ 68,485.20	$2.630
Clearing cost		1,041.60	.040
Depreciation of tools		542.50	.021
Felling and bucking labor		17,100.00	.657
Total	26,040M	$ 87,169.30	$3.348
Deduct—inventory of logs felled and bucked	570M	1,908.08	3.348

Felling and bucking cost of logs rigged	25,470M	$ 85,261.22	$3.348
Rigging maintenance		4,850.00	.190
Rigging labor		36,550.00	1.435
Depreciation of cable		3,480.90	.137
Cost of logs rigged	25,470M	$130,142.12	$5.110
Other operating costs:			
Depreciation of skidroads		12,310.50	.483
Other operating expenses		900.00	.035
Net cost of operating wangan (schedule I)		2,090.00	.082
Net cost of operating cook-house (schedule II)		590.00	.024
Cost of logs rigged and placed in water	25,470M	$146,032.62	$5.734
Deduct—inventory of logs in water	2,320M	13,301.75	5.734
Cost of logs sold	23,150M	$132,730.87	$5.734

No. 4 (10 points):

A certain company has an agreement with its president to pay him a bonus of 10 per cent. of that portion of the net profit, after deduction for federal income tax, which is in excess of 6 per cent. of the invested capital. Invested capital amounts to $300,000.

The profit, before deduction for bonus and tax, was $50,000 and the bonus, to be paid, is a deductible item in computing the tax.

What is the company's net income—i. e., less bonus and tax—and what the true rate of return on investment?

Solution:

Let B equal the bonus

and let T equal the tax.

Since the bonus is to be "10 per cent. of that portion of the net profit, after deduction for federal income tax, which is in excess of 6 per cent. of the invested capital" of $300,000,

$$B = .10(\$50,000 - \$18,000T) \qquad (1)$$

And since the tax is 12 per cent. (corporation rate for the year 1930) of the net profit after deducting the bonus,

$$T = .12(\$50,000B) \qquad (2)$$

$$\text{or } T = \$6,000 - .12B \qquad (3)$$

Solving for B:

$$B = .10(\$50,000 - \$18,000T) \qquad (1)$$

$$\text{or } 10B = \$32,000T \qquad (4)$$

Substituting the value of T in equation (3) for the value of T in the equation (4), we have:

$$10B = \$32,000 - (\$6,000 - .12B)$$

Removing the parentheses and changing signs:

$$10B = \$32,000 - \$6,000 + .12B$$

$$10B - .12B = \$32,000 - \$6,000$$

$$9.88B = \$26,000$$

$$B = \$2,631.58$$

Solving for *T:*

$$T = \$6{,}000 - .12B \tag{3}$$
$$T = \$6{,}000 - .12(\$2{,}631.58)$$
$$T = \$6{,}000 - \$315.79$$
$$T = \$5{,}684.21$$

Proof

Computation of tax:

Net profit before deducting bonus and tax	$50,000.00
Deduct bonus	2,631.58
Taxable net income	$47,368.42
Rate of tax for the year 1930	12%
Tax (12% of $47,368.42)	$ 5,684.21

Computation of bonus:

Net profit before deducting bonus and tax	$50,000.00
6 per cent. of invested capital of $300,000	18,000.00
Remainder	$32,000.00
Tax	5,684.21
Net profit before bonus	$26,315.79
Bonus (10% of $26,315.79)	$ 2,631.58

While the problem states that the bonus is to be 10 per cent. of the "net profit," and it might well be said that the bonus must be considered as an expense in determining "net profit," it does not seem that the examiners intended that the bonus be treated as an expense in arriving at the amount of the bonus, for "the profit, before deduction for bonus and tax, was $50,000 and the bonus, to be paid, is a deductible item in computing the tax." If it were the intention of the examiners that the bonus be deducted as an expense in ascertaining the amount of the bonus, this point, no doubt, would have been specifically mentioned in the problem.

Computation of the true rate of return on the investment:

Net profit before deducting bonus and tax		$50,000.00
Deduct:		
Bonus	$ 2,631.58	
Tax	5,684.21	8,315.79
Net profit for the year		$41,684.21

The rate of return on the invested capital of $300,000 is, therefore, $41,684.21 ÷ $300,000 or	13.8947%

The rate of return on the average invested capital for the year is:

Invested capital beginning of year	$300,000.00	
Invested capital end of year	341,684.21	
Total	$641,684.21	
Average invested capital for year	$320,842.10	
Rate of return—$41,684.21 ÷ $320,842.10 =		13.00%

No. 5 (10 points):

A corporation has outstanding $14,000,000 in 6 per cent. bonds, due in 5 years. Interest is payable annually. The corporation desires to retire these bonds by a new 4½ per cent. issue, also due in 5 years.

The brokers suggest an issue of a stated larger amount to be issued mostly to the old bondholders, the balance to be the brokers' commission. No cash is to be received or paid.

This, apparently, should result in a considerable saving in interest, but you point out to the corporation that the cost will, eventually, be about the same.

What amount of bonds did the brokers suggest?

Given: $(1.045)^5 = 1.246182$

Solution:

The proposal of the brokers, in effect, is to exchange or sell $14,000,000 + X of 4½ per cent. five year bonds for the $14,000,000 of 6 per cent. five-year bonds outstanding. The bonds to be issued in the amount of X will constitute bond discount which must be written off over their five-year life. The amount of X is, therefore, that amount of bonds, which added to the $14,000,000 already outstanding, all of which are to bear a coupon rate of 4½ per cent. (interest payable annually) will not cost the corporation more than $840,000 per annum (the present interest charge of 6 per cent. on the $14,000,000 outstanding) in interest and amortization of the amount of the X bonds. The problem gives $(1.045)^5 = 1.246182$, indicating that the sinking fund to retire the additional par of bonds to be issued is to bear a rate of 4½ per cent. The annual contribution to the sinking fund may be ascertained as follows: $(1.246182 - 1) \div .045 = 5.4707$ which is the amount of an annuity of 1. The annual contribution is, therefore, $X \div 5.4707$.

The proposition may be stated as follows:

$$\$840{,}000 = .045(\$14{,}000{,}000 + X) + \frac{X}{5.4707}$$

$$\text{or } \$840{,}000 = \$630{,}000 + .045X + .18279196X$$

$$\text{or } .22779196X = \$210{,}000$$

$$X = \$921{,}893.82$$

The proposed issue would approximate $14,921,893.82.

Proof

Present interest charges—6% of $14,000,000	$840,000.00
Interest at 4½% on $14,921,893.82	671,485.22

Saving to be deposited into a sinking fund and to bear interest at 4½%	$168,514.78
The amount of the saving, $168,514.78 multiplied by the amount of an annuity of $1 for five years at 4½%—5.4707	$921,893.82

While the preceding solution is based upon the assumption that the sinking fund to amortize the amount of the additional bonds is to bear interest at 4½ per cent., the argument may be advanced that the issuance of 4½ per cent. interest bearing bonds in the larger amount in exchange for the $14,000,000 of 6 per cent. bonds indicates an effective rate of 6 per cent., which rate should be used in computing the annual contribution to the sinking fund. In the alternative method which follows, this 6 per cent. rate is used.

A rather common problem is to give the candidate the par, interest rates, present values, etc., and to require the computation of the price at which the bonds are to be sold. In this problem, we have the price, i. e., $14,000,000. The proposition may then be expressed—

Price = (par times present value of 1) + present value of an annuity of 1 times coupons.

Or:

$$\$14{,}000{,}000 = (X \,.\, p) + P(X \,.\, .045)$$

Or:

$$\$14{,}000{,}000 = .74725817X + 4.21236379(.045X)$$
$$\$14{,}000{,}000 = .74725817X + .18955637X$$
$$.93681454X = \$14{,}000{,}000$$
$$X = \$14{,}944{,}259.94$$

Proof

Present interest charges	$840,000.00
Interest at 4½% on $14,944,259.94	672,491.70
Saving to be deposited into a sinking fund	$167,508.30
The amount of the saving of $167,508.30 multiplied by the amount of an annuity of $1 for five years at the effective rate of 6%—5.63709296	$944,259.94

Institute Examination in Law

By Spencer Gordon

[The following answers to the questions set by the board of examiners of the American Institute of Accountants at the examinations of November, 1931, have been prepared at the request of The Journal of Accountancy. These answers have not been reviewed by the board of examiners and are in no way official. They represent merely the personal opinions of the author.—*Editor*, The Journal of Accountancy.]

Examination in Commercial Law

November 13, 1931, 9 A.M. to 12:30 P.M.

Group I

Answer all questions in this group.

No. 1:

John Mason at the request of Walter Burroughs lent $150 to Burroughs, stating at the time that he, Mason, owed that amount to Charles Evans to whom he was obligated to pay it ten days thereafter. Burroughs, in consideration of the loan and at the time of receiving the $150, promised Mason that he, Burroughs, would pay $150 to Evans ten days thereafter. Evans knew nothing of this loan and promise until he tried unsuccessfully to collect from Mason. After Burroughs' failure to pay, can Evans recover in an action brought by him against Burroughs?

Answer:

In most jurisdictions Evans can recover from Burroughs on a contract thus made for his benefit when it results from a debtor-creditor relation between himself and one of the parties and is not a mere gratuity. Evans' ignorance of the contract would be immaterial.

No. 2:

Prentice made a valid contract with Adams whereunder Adams was to sell Prentice's goods on commission during the period from January 1, 1931, to June 30, 1931. Adams made satisfactory sales up to May 15, 1931, and was then about to close an unusually large order when Prentice suddenly and without notice revoked Adams' authority to sell. Can Adams continue to sell Prentice's goods during the unexpired term of his contract?

Answer:

The authority given Adams by contract to sell Prentice's goods on commission created a sales agency which could be terminated at any time, notwithstanding the contract period had not expired. Adams can recover damages for breach of his contract, but he no longer has authority to sell Prentice's goods and can not force Prentice to deliver.

No. 3:

Carlin borrowed $10,000 from White for one year, giving as security a mortgage upon real estate.

(a) Six months later, Carlin died. At the maturity of the loan, what rights has White and against whom can he enforce them?

(b) If White instead of Carlin had died six months after the loan was made, to which of the following persons should Carlin make payment at maturity—White's legatees, heirs, testamentary trustee, administrator, next of kin, executor, devisees?

(a) Unless state statutes prescribe a different course, White may present his entire claim to the estate for allowance as a secured claim and receive payment if the heir or devisee of the land is entitled to exoneration, or he may foreclose the mortgage at maturity and claim against the estate for the unpaid balance only.

(b) Carlin should pay White's executor or administrator at maturity.

No. 4:

Sanborn in June, 1928, while entirely solvent, executed and gave to his wife as a gift a formal bill of sale of his interest in the Mann Drug Corporation, in which he owned 110 shares of stock, but he retained the stock certificate, the stock was not transferred on the books of the corporation, the corporation was not notified of the bill of sale, and Sanborn continued to vote on the stock and receive dividends until April, 1931. At that time he was hopelessly insolvent and knew it, but without receiving any consideration he indorsed the certificate for these 110 shares to his wife, who had the transfer recorded on the corporation's books. Was this transfer of stock fraudulent as against Sanborn's creditors?

Answer:

The transfer is fraudulent as against Sanborn's creditors. The uniform stock transfer act requires delivery of the certificate itself to effect transfer, and an attempted transfer without such delivery amounts only to a promise to transfer. When such implied promise is without consideration, a subsequent transfer in pursuance thereof, if made when the transferor is insolvent, is fraudulent as against his creditors.

No. 5:

Atwood and Chapin were partners and their business was insolvent. Atwood fraudulently represented to Morton that the firm's business was solvent and thereby induced Morton to become a partner and to make a capital investment of $10,000. As soon as Morton discovered the fraud, he personally obtained possession of most of the firm's assets and then notified his partners that he had withdrawn from the firm. Thereafter a creditor of the firm whose claim had arisen prior to Morton's becoming a partner, sued all three partners.

(a) What is the extent of Morton's liability, if any, to the creditor who was suing?

(b) What rights has Morton with respect to the fraud perpetrated on him?

Answer:

(a) Morton has no liability to the creditor of the old partnership if the value of the assets taken by him do not exceed his capital investment. Fraud in the inception of a partnership makes it voidable from the beginning except as to third persons who have given credit to the new firm. The uniform partnership act allows the defrauded partner to retain firm assets to the extent of his investment after satisfying partnership liabilities to third persons. Partnership liabilities within the meaning of this section would appear to include only creditors of the new firm, and while the act makes an incoming partner liable to the extent of the new firm's assets to creditors of the old firm, I do not think this would be interpreted to include a partner who is entitled to rescission since a rescinded partnership is generally considered void from its inception so far as creditors of the old firm are concerned. I have in mind also that in this case the assets available for the creditor do not appear to have been lessened by the entry and withdrawal of Morton so long as he takes out no more than he put in.

The creditor should not be allowed to better his position by taking advantage of the fraud practised on Morton.

(b) Morton is entitled to rescind, and, subordinate to creditors of the new firm, has a lien on firm assets, or may retain them, to the extent of his investment. He has the same rights as other creditors, but subordinate to creditors of the new firm, to recover any payments made by him for the account of the firm. He is entitled to be indemnified by Atwood against all debts and liabilities of the partnership, and may recover against Atwood all damages suffered.

Group II

Answer any five questions in this group. No credit will be given for additional answers, and if any are submitted only the first five answers will be considered.

No. 6:

In what ways or by what means can the existence of a corporation come to an end?

Answer:

A corporation's existence may be terminated in the following ways:

(1) Forfeiture of its franchise by the adjudication of a court.

(2) Loss of its charter by a charter provision to that effect in case the corporation fails to meet certain requirements.

(3) Repeal of its charter under the reserved power of the state.

(4) Voluntary surrender of the franchise by the stockholders.

(5) Expiration of the time limited for its existence in the charter.

No. 7:

A policy of fire insurance issued to a partnership in its firm name makes no mention of changes in the personnel of the firm.

(a) Does the subsequent withdrawal of a partner affect the validity of the policy?

(b) Does the subsequent admission of a new partner affect the validity of the policy?

Answer:

The withdrawal of a partner as a general rule does not vitiate an insurance contract on partnership property, although contrary results have been reached in a few jurisdictions on the wording of particular policies. The alienation clauses of policies are more strictly construed when new partners are admitted, however, and it is held that this avoids a policy prohibiting any change in title or possession of the property.

No. 8:

(a) What is a conditional sale and how does it differ from a lease with an option to purchase?

(b) How in general can a conditional vendor protect his rights?

Answer:

(a) A conditional sale is one in which title to goods sold and delivered on credit is reserved in the vendor until payment.

The principal difference between a conditional sale and a lease with option to purchase is that the latter does not obligate the lessee to pay the purchase price unless the option is exercised. This difference is one of substance, however, not of form, and when the so-called lessee is obligated to pay as rent an amount substantially equal to the purchase price, the transaction is held to be a conditional sale.

(b) In general, a conditional vendor can protect his rights by recording the conditional sale.

No. 9:

Tompkins makes a negotiable promissory note payable to the order of the First National Bank and before delivery Chase writes his name on the back of it. What kind of endorser, if any, is Chase and what is his liability, if any, to the payee and to subsequent endorsees?

Answer:

Chase is an accommodation endorser. He is liable on the note to the payee or any subsequent holder for value to the same extent that any other endorser would be.

No. 10:

(a) What is meant by an act of bankruptcy?

(b) Name the various acts of bankruptcy.

(c) What is a referee in bankruptcy, how does he obtain his position as referee, and what in general are his duties?

(d) What is a trustee in bankruptcy, how does he obtain his position as trustee, and what in general are his duties?

(e) What debts, if any, are not affected by a discharge in bankruptcy?

Answer:

(a) Acts of bankruptcy are defined by statute. The commission of any one of them within four months is a prerequisite to the filing of a petition in involuntary bankruptcy against the person committing such act, if at the time of filing such petition that person is insolvent.

(b) An act of bankruptcy is committed by:

(1) Conveying, transferring, concealing or removing property with intent to delay or defraud creditors.

(2) Transferring property while insolvent to any creditor with intent to prefer such creditor.

(3) Suffering or permitting, while insolvent, any creditor to obtain a preference through legal proceedings and not having such preference discharged.

(4) Making of a general assignment for the benefit of creditors, applying for a receiver or trustee while insolvent, or having a receiver or trustee of one's property appointed because of insolvency.

(5) Admitting in writing one's inability to pay debts and willingness to be adjudged a bankrupt.

(c) A referee in bankruptcy is an officer of the court of bankruptcy, appointed by the court, and to whom the petition in bankruptcy is referred. His duties in general are to supervise the administration of bankrupt estates.

(d) A trustee is an officer of the court of bankruptcy, appointed by the creditors in meeting, or, in event of their failure to appoint, by the court. His general duties are to collect, conserve and liquidate the assets of the estate, pay dividends as declared by the referee, keep accounts and make reports on the estate.

(e) Briefly, a discharge in bankruptcy will not release debts for taxes; liabilities for obtaining property fraudulently; for willful and malicious injuries, alimony, maintenance of wife or child, seduction of unmarried female, breach of promise and seduction, or criminal conversation; unscheduled debts to creditors without notice or knowledge of proceedings; fraudulent debts created by bankrupt while acting as officer or in fiduciary capacity; wages earned within three months by workmen, clerks, salesmen, or servants; and debts due employees for money received or retained to secure faithful performance of employment contracts.

No. 11:

A testamentary trustee duly made an authorized purchase of 400 shares of capital stock (of the par value of $100 each) at 120. Subsequently he received 400 rights entitling him to subscribe to 100 additional shares at 100. Entirely regardless of taxable income, how should the trustee render account, distinguishing between principal and income of the trust, in each of the following cases:

(a) The trustee exercised his rights and later sold 40 shares at 130.

(b) The trustee did not exercise his rights but sold all the rights at $4.50 each.

Answer:

Corporate stock rights and increase in value of corporate stock itself are generally held to be part of the principal of the trust estate, not income. Some jurisdictions depart from this rule with regard to rights, and hold as income so much of the value of the rights as represents undivided profits of the corporation accumulated since the acquisition of the stock by the trust, decreased by any loss in value of the stock from date of acquisition. Similarly, a few jurisdictions hold that so much of the increased value of stock as is represented by undivided profits is income. The only answer to (a) and (b) is therefore that authorities differ.

No. 12:

A corporation in 1925 constructed a factory building for its own use at a cost of $200,000. In 1929 it was insured for $250,000, and upon a total loss by fire during that year the entire amount of the insurance was received from the insurance company. Two hundred thousand dollars of this insurance money was immediately invested in the construction of a new factory which was sold in 1931 for $175,000. In what years and in what amounts would any taxable gain or deductible loss be recognized under the revenue act of 1928? (In your computations, disregard depreciation.)

Answer:

Assuming the new factory was similar or related in service or use to the old factory, gain in 1929 is only recognized to the extent of the insurance money not expended in the acquisition of the new factory. This taxable gain would amount to $50,000 in 1929 since $200,000 of the $250,000 was expended for the new factory. Deductible loss would be sustained in 1931 in the sum of $25,000 arrived at as follows: The basis or cost of the old factory was $200,000 which is to be decreased by the insurance money ($50,000) not expended for the new factory and increased in the amount of gain ($50,000) recognized upon the conversion of the property in 1929; the resulting basis being $200,000 and the property selling for $175,000 in 1931, deductible loss of $25,000 is sustained in 1931.

Corporation Reports

On January 12th the stock list committee of the New York stock exchange issued the following letter addressed to the chief executives of corporations:

Dear Sir: In line with our constant efforts to secure reasonable uniformity in annual reports for the benefit of listed companies, their share-holders, accountants, and the investing public, this committee is herewith advising you of its general attitude as to the following features of such reports:

(1) When the books and accounts have been audited by public accountants, the text of their auditor's certificate should be given.

(2) The number of shares of capital stock, both common and preferred, authorized by the charter and the amount outstanding should be shown in the balance-sheet.

(3) The number of shares and the amount of holdings of own unretired stock and bonds should be separately disclosed, with indication of the valuation and the basis at which carried.

(4) Surplus should be separated at least into capital surplus and earned surplus. If all surplus is earned surplus (representing realized profits) it should be so designated.

(5) Any changes for the period covered in either capital surplus or earned surplus should be indicated by adjustments thereto.

(6) Differences between cost and subsequent retirement or resale of the company's own stock should be fully disclosed. This committee prefers that such differences be reflected directly to the capital surplus account, especially where common stock, and preferred stock without compulsory retirement features are involved. There is, however, some difference of opinion among accountants upon this point, and there are those among them who consider that such differences may properly be reflected in earned surplus instead of in capital surplus. Listed corporations are generally under agreement to submit future statements to stockholders in the same form as those contained in the listing application. Where it has been the practice of such corporations to reflect any so-called profits arising from these transactions through the capital surplus account, this committee feels that it would be a violation of the agreement in question should any change in the practice be made. Until further consideration of the matter, however, no objection will be made if corporations, whose practice in this respect is not affected by the agreement to publish in the same form, should follow the advice of their accountants upon this point, provided full disclosure of the source of such additions is given and that the transactions are included directly in the surplus account and not in the income account.

(7) Full disclosure should be given of any change since the previous annual report in the basis of valuation in investments, inventories, or property account.

(8) Full disclosure of any change in the depreciation policy should be given.

(9) If other income represents a substantial part of total income, the principal component items of other income should be disclosed.

(10) This committee does not deem it advisable to establish at this time requirements as to the method by which revised or fluctuating rates of foreign exchange should be reflected in the consolidated balance-sheets or earnings statements of listed American companies having foreign subsidiaries subject to these

factors, or in the parent company statements of listed American companies themselves having assets, liabilities, or earnings similarly affected. Irrespective of the method followed, disclosure should be given of the basis on which such items are reported.

(11) A list of officers and directors should be included in the report.

This circular letter is not intended to affect in any way cases in regard to the above points which already have been taken up individually with this committee.

Book Reviews

PHILANTHROPY FOR THE FUTURE, edited by ALFRED WILLIAMS ANTHONY. Published by the *Federal Council of the Churches of Christ in America.* 150 pages.

Philanthropy for the Future is a compilation of papers presented at the fourth conference on financial and fiduciary matters held at Atlantic City, March 17–19, 1931. The only item of interest to accountancy as a profession is the strong recommendation of the presiding officer, Lewis B. Franklin, that

> "Too much emphasis can not be placed upon the need of thorough and regular audit of a professional and unbiased character."

Otherwise most of the papers are concerned with methods of making drives for funds, their custody and safeguarding, appraisals of charities and institutions as to objects and usefulness, etc.—all of which are intensely practical and familiar to those who are interested in philanthropic affairs.

Mark M. Jones leads off with a rather stupendous proposition to create about fifteen or twenty regional foundations with perpetual funds. Seven hundred and fifty millions are to be invested in buildings and equipment of beneficiary institutions; and investment funds of not more than half a billion for each foundation are to be raised and the income thereof to be distributed to all institutions, charitable, religious and educational, in accordance with their budget needs. Present endowments of individual institutions are to be turned over to the foundations as far as possible and the system of endowing particular institutions is to be discouraged. In effect it would be a development on a large scale of the community-chest idea. It is all very neat and compact, but it seems like a dream of a philanthropic millennium.

W. H. LAWTON.

ACCOUNTING PROBLEMS: INTERMEDIATE, by CHARLES F. RITTENHOUSE and ATLEE L. PERCY. *McGraw-Hill Book Co., Inc.*, New York. 460 pages.

This second edition of *Accounting Problems: Intermediate* (the first was published in 1922) is a vivid reminder of the progress and changes in business affairs in the last ten years. Mass production, keener competition, elimination of wasteful methods, extension of trade, have all had a profound effect upon manufacture and trade, and it is gratifying to reflect that the profession of accountancy, both private and public, has had its share in improving methods of recording and measuring that progress. Certainly no one can recall C. P. A. examination questions of the period before the great war without noting the higher standards required by those of to-day. Basic principles are the same, of course, but the methods of applying them in practice have become, paradoxically, more complex yet more simplified.

This text-book by Messrs. Rittenhouse and Percy is strictly laboratory material for the use of students who have mastered the elementary and much of the higher accounting. The first ninety pages contain a series of financial statements showing the highest standards as adopted by business organizations. Their scope covers a wide variety of organizations and lines of business. Comments and suggestions help the student to understand the significant and vital points that proper statements should disclose.

With these as models, the rest of the book consists of practical and theoretical problems to be worked out, taken mainly from examination papers of the American Institute and various C. P. A. examining boards. They are conveniently classified to enable instructor and student to proceed in an orderly and scientific manner.

With the knowledge and practical training offered in this excellent textbook students should be amply prepared for junior positions, and later able to take C. P. A. examinations with every confidence.

W. H. Lawton.

PROBLEMS IN BUSINESS STATISTICS, by T. H. Brown. *McGraw-Hill Book Co., Inc.*, New York, 1931. 500 pages.

The series of "Harvard Problem Books"—text books for students in the business departments of Harvard—grows longer. *Problems in Business Statistics* keeps up the high standard set by earlier books of the series.

As usual with Harvard business text books this is a "case book." Corporations and others have contributed of their experience so generously that the variety of applications of statistical methods available for and used by Professor Brown in these study cases is bewildering.

The uses of statistical information and graphs for business enterprises is pointed out, of course, but the failure of statistics to give invariably trustworthy guidance is not minimized nor is there any attempt to hide the fact that statistics may be honestly compiled from differing viewpoints with correspondingly differing results. Very frequently the student is confronted with two or more treatments of the same set of facts with differing bases of weighting and asked to choose between them, giving reasons for the choice.

Of the specific cases given (with the true names of the corporations involved) many are statements of experience to date with varying compilations of statistics—the ultimate value of them still to be determined. The student is asked to give an opinion as to probable future results and to make suggestions for improvement, if any occur to him.

After reading through a large part of the book it is noticed that not one passage has been met that made the reader conscious of the personality of the author. One finds no business slang; no cruel and unusual words; no poor English; such clarity of expression that a tedious subject is made easy to read. One reading, however, is like a half-day trip to New York—the sky line and the railway station are all that is clearly remembered. A year of study would be necessary to exhaust all that the book contains.

An appendix gives the sources from which may be obtained current data needed for statistical matter affected by the general business situation.

The modern student of business cycles, trends, statistics, etc., is to be congratulated upon the existence of this and similar Harvard business publications. There were no such advantages when his predecessors studied business administration.

F. W. Thornton.

SIMPLIFIED MATHEMATICS FOR ACCOUNTANTS AND EXECUTIVES, by HARRIS D. GRANT. *McGraw-Hill Book Co., Inc.*, New York, 1931. 329 pages.

Simplified Mathematics is not the work of a college professor of the academic type but of a truly practical man, who has a thorough knowledge of his subject. There is not a single algebraic or logarithmic formula to be found in the book, and the author is not too stilted to advise the use of bond and interest tables in the solution of the problems.

No doubt algebra may be used with a certain amount of success in the solution of some commercial problems, provided it be used by one who has a comprehensive knowledge of it and provided also that he be so much in the habit of using it in his daily life that his knowledge has not become rusty. Executives who have acquired and preserved this facility in the use of algebra are few; and, while there are many public and other accountants who have the knowledge and practice, they usually have to communicate their results to clients who do not understand algebra, distrust what they do not understand and must be convinced of the correctness of the accountant's figures without having recourse to it. Unfortunately most of those who rely upon algebra have never taken the trouble to learn the processes whereby results, ordinarily obtained by algebraic methods, may be obtained by simple arithmetic, most easily with the aid of interest and bond tables.

This book fills exactly the needs of accountants who may have to make involved computations and explain them without the use of algebra. There is probably no commercial calculation that can not be made with reasonable ease by methods given by Mr. Grant, often involving the use of interest and bond tables.

Executives are seldom sufficiently industrious to study such a book as this; if they do study it they will be well repaid. Accountants, public and other, really ought to get this book and study it carefully—not merely buy it, put it in the library and forget about it.

It is a worthy book; whatever one's business, however involved the computations it involves, this book will fit the case.

With a reviewer's usual nasty disposition, I have searched the work for something at which to carp. All I can find to criticise is the fact that in the effort to be concise the author is sometimes a little obscure.

F. W. THORNTON.

Accounting Questions

[The questions and answers which appear in this section of THE JOURNAL OF ACCOUNTANCY have been received from the bureau of information conducted by the American Institute of Accountants. The questions have been asked and answered by practising accountants and are published here for general information. The executive committee of the American Institute of Accountants, in authorizing the publication of this matter, distinctly disclaims any responsibility for the views expressed. The answers given by those who reply are purely personal opinions. They are not in any sense an expression of the Institute nor of any committee of the Institute, but they are of value because they indicate the opinions held by competent members of the profession. The fact that many differences of opinion are expressed indicates the personal nature of the answers. The questions and answers selected for publication are those believed to be of general interest.—EDITOR.]

LIABILITY OF A SUBSIDIARY CORPORATION

Question: An industrial corporation with a long and prosperous history proposes to sell a substantial portion of its capital stock to the public. The buildings in which it operates are owned by a separate corporation, the capital stock of which is owned entirely by the first-named corporation. For purposes of abbreviated identification, we shall refer hereafter to (a) the industrial corporation and (b) the realty corporation.

The realty corporation has leased its property for a long term of years to the industrial corporation at a rental sufficient to care for principal amortization and interest on a bonded debt of $500,000 which is a first lien against the realty. The property is appraised at $2,000,000, hence the net equity of the realty corporation is $1,500,000. Aside from the property and the mortgage debt, the assets and liabilities of the realty corporation are nominal and need not be considered for our purposes.

Bankers have undertaken to market the stock of the industrial corporation and, incidentally, financial and operating statements are required. The bankers wish the balance-sheet to show the assets and liabilities of the industrial corporation only and are opposed to a consolidated financial statement. The bankers insist that the investment of the industrial corporation in the realty corporation shall be shown among the assets as "net worth of a wholly-owned realty corporation, at appraised valuation, $1,500,000." It is contended that the disclosure of the bonded debt of $500,000 will render more difficult the sale of the stock of the industrial corporation.

To the contention that an important liability of the affiliated group is hidden, the bankers reply, "We are selling the stock of the industrial corporation and the public is interested primarily in its individual financial status and earning power and, furthermore, the liability is that of the realty corporation only and the industrial corporation is not affected."

May an accountant issue such a balance-sheet as the bankers demand? If the answer is "No," a statement which will effectively overthrow the bankers' position is desirable.

Answer No. 1: There can be no doubt that in the present instance the funded-debt liability of the subsidiary is a matter of greater importance to the stockholders of the parent company (by reason of the fact that this funded debt is a lien against the premises in which the parent company conducts its operations) than would be the case if the subsidiary stood, so to say, in a definitely separated position. Since this funded debt of the subsidiary is so closely related to the business of the parent company, it seems to us that the balance-sheet to be presented should indicate the existence of this liability against the operated premises of the parent company.

The recently promulgated instructions of the New York stock exchange, regarding agreements to be made by companies listing their securities, require extensive information with regard to any subsidiary omitted from the consolidation. It is true that the information required does not go so far as to involve a disclosure of a liability of this nature; but we are of opinion that, as these requirements of the New York stock exchange represent a distinct progress in the matter of revelation to the public of pertinent information, further progress in the future will embrace such matter as that mentioned in your letter.

As we view the matter, the proposed balance-sheet caption covering the parent company's investment in the subsidiary—"net worth of a wholly-owned realty corporation, at appraised valuation, $1,500,000"—should at least be expanded to indicate, if not the amount, certainly the existence of such funded debt; perhaps some such parenthetical expression after "net worth," as "property less mortgage indebtedness" might do. We presume that the bankers, in giving information in the offering circular concerning the affairs of the company to be financed, will mention the ownership by the wholly-owned subsidiary of the premises occupied by the parent company; such mention, together with the above-suggested parenthetical remark, would, it seems to us, be the least that should be brought out regarding the matter.

Answer No. 2: In the circumstances we do not think the accountant need insist upon a consolidated financial statement, but we do think that if the accounts of the realty corporation are not consolidated, the amount of its bonded indebtedness must be shown clearly upon the face of the balance-sheet to be issued. The wording suggested by the bankers, "net worth of a wholly-owned realty corporation at appraised valuation—$1,500,000," does not seem to us satisfactory, since it merely hides the existence of a very substantial liability behind the one word "net" and can not be considered a fair disclosure. The argument put forward by the bankers, namely, that the public is interested primarily in the individual financial status and earning power of the company whose stock they are buying, is the very reason, it seems to us, why the liability in question should be disclosed. In circumstances such as these, the profits of the business (for instance where the business in question is that of a department store) may depend to a very great extent upon its location, and the arrangements which the company has made to secure that location have a direct bearing on the prosperity of the business and hence on the value of the stock being sold. It is from the profits of the business, as your correspondent's letter indicates, that the interest and amortization on the bonded debt will have to come, and this fact we think is pertinent and should certainly be disclosed.

In one particular instance where a similar question arose in our own practice, the facts were shown as follows:

Outside properties	$3,000,000	
Less—real estate mortgages (obligations of subsidiary companies)	1,000,000	
		$2,000,000

Some such disclosure seems to us to be necessary in the present case.

BASIS OF ACCOUNTING BY NEWSPAPERS

Question: We have found that a number of the smaller daily newspapers on the Pacific coast follow the practice of keeping their accounts on a cash-receipts-and-disbursements basis, instead of upon the accrual basis. We wish to ascertain whether in the eastern part of the United States that practice is followed to any considerable extent by such newspapers in cities of, say, 25,000 to 50,000 population.

Answer: (Results of a questionnaire to ascertain the practice among New England newspapers.)

In the digest of replies following, No. 1 column applies to newspapers keeping accounts on a cash basis; No. 2 on accrual basis; No. 3 as circulation department accounts; No. 4 to classified advertising accounts, and No. 5 to the basis used in filing income-tax returns. Preceding each is the approximate circulation.

Approx. circulation	No. 1	No. 2	No. 3	No. 4	No. 5
7,000		x	Cash	Cash	Accrual
3,500	x		Cash	Cash	Cash
16,500	x		Cash	Cash	Cash
16,000		x	Cash	Accrual	Accrual
3,500		x			Accrual
5,000		x	Cash	Cash	Accrual
9,500		x	Accrual	Accrual	Accrual
9,000		x	Accrual	Accrual	Accrual
7,500		x	Both	Both	Accrual
22,000	x		Cash	Cash	Cash
6,500			Cash	Accrual	Accrual
40,000		x	Accrual	Accrual	Accrual
8,000		x	Accrual	Accrual	Accrual
13,000		x	Accrual	Both	Accrual
32,500		x	Accrual	Accrual	Accrual
5,500	x		Cash	Cash	Cash
7,500	x		Cash	Cash	Cash
4,500	x		Cash	Cash	Cash
(a) 20,000	x		Cash	Accrual	Accrual
(b) 14,000		x	Accrual	Accrual	Accrual
(c) 60,000	x		Cash	Cash	Cash
(d) 105,000		x	Accrual		Accrual

	Approx. circulation	No. 1	No. 2	No. 3	No. 4	No. 5
(e)	22,500		x	Accrual	Accrual	Accrual
	30,000		x	Accrual	Cash	Accrual
	17,000		x	Cash	Accrual	Accrual
(f)	30,500	x				
(g)	8,500		x	Cash		Accrual
	135,000		x	Cash	Accrual	Accrual
	5,750	x	x	Cash	Cash	Both
	7,500	x	x	Cash	Cash	Both
	18,000		x	Accrual	Accrual	Accrual
	16,000		x	Accrual	Accrual	Accrual
	12,000	x		Cash	Cash	Cash
	34,000		x	Cash	Accrual	Accrual

NOTES

(a) "Changing to accrual basis on circulation January 1, 1932. General expenses all kept on cash disbursements."
(b) "Leaving out accounts receivable does not present a correct picture of one's business."
(c) "While perhaps our methods are somewhat old-fashioned and cumbersome, they are, nevertheless, simple, and we believe them most effective under our conditions."
(d) "Classified, prepaid ads are naturally cash and there is nothing to accrue on the charges."
(e) "We intend very soon to carry all local and national accounts on accrual basis as at present, but in case of classified and circulation to use cash-receipts basis only."
(f) Questions 3, 4 and 5, answered "on actual earnings."
(g) "Cash receipts for transients. Accrual for those who have display accounts."

Current Literature

Compiled in the Library of the American Institute of Accountants

[Photostatic reproductions (white printing on a black background) of most of the articles listed in THE JOURNAL OF ACCOUNTANCY or *Accountants' Index* may be obtained from the library of the American Institute of Accountants, 135 Cedar Street, New York, at a rate of 25 cents a page (8½ in. x 11 in.), at 35 cents a page (11½ in. x 14 in.), plus postage. Members and Associates of the American Institute of Accountants are entitled to a discount of 20 per cent. Identify the article by author, title, name of periodical in which it appeared, date of publication and paging. Payment must accompany all orders.]

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